ForeX Trading for Maximum Profit

VISIT…

ForeX Trading for Maximum Profit

THE BEST KEPT SECRET *OFF* WALL STREET

RAGHEE HORNER

EDITED BY JEFFREY ALAN BRANDZEL

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To my Ma, Nila, and Herbie. You are all my reasons.

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Introduction

You are reading this book for one simple reason: You want to trade Forex successfully, which is to say you want to be a profitable Forex trader. I'm not going to lose sight of this fact. In fact, I can tell you why I chose to take on the painstaking effort of writing this book.

About four years ago, more than a few of my students wanted to trade Forex and I did not have a book or course to recommend to them. I did visit many bookstores in an effort to find even one book that I felt provided would-be Forex traders a methodology they could follow. My search yielded no results. Let me tell you what I did find. I found books that discussed the history of the Forex, books that discussed the interbank relationship, books that discussed the pairs and fundamentals of the Forex market, and finally books that discussed all the patterns and indicators you could use in the Forex market. I call the last type of book "glossary" books because that's all that they are: a collection of definitions and descriptions with no step-by-step methodology.

I was frustrated. Surely there had to be a book that discussed a proven style of Forex trading that wasn't reliant upon a software system or proprietary approach. That was when I finally decided to start writing, if for no other reason than to share what I had learned after over a decade in the markets. When people ask me about the Forex market I tell them that it has the best features of all the other markets with none of the problems. I still feel this way. What other market can guarantee stops? What other market has zero commissions? (We do pay the spread and I will discuss that in-depth, but consider that you often pay the spread in stocks and futures as well.) What other market has 24-hour liquidity? What other market trades with no gaps Monday through Friday? These are qualities that make for a "dream" market.

I have to admit, maybe there's a bit of vanity, too. I wanted to share my style and my views. I envisioned a dialogue between myself and you the reader. I envisioned that some of my statements might raise an eyebrow and others a smile. I wanted to shatter myths that have propagated in the markets regarding trading. More than anything I wanted to set forth a tried and true formula for trading success; a formula that didn't rely on systems and complex calculations, one that would be as effective for a new trader as for the seasoned trader. Please don't be fooled into thinking that a successful trading approach needs to be complicated. It doesn't. Some of you will have to take my word for it and some of you already know this.

If there is anything that has continued to serve me well as I trade the markets it is my willingness to question. Have you

ever wondered why trading types like scalping, momentum, or swing trading, areas defined by how long you are in the trade? That couldn't be further from the truth and we discuss that in Chap. 15, "The Difference Between Scalping, Momentum, Swing, and Position Trading. Ever wonder what "multiple confirmation" is or why it's important? That very question was asked of me during the interview conducted for this book. Ever wonder which economic reports a Forex trader must be on the look out for and how to gauge the market's reaction to their release? We'll talk about that in Chap. 25, "News Discounting." Did you know that most traders learn and use the wrong type risk management for trading? This is exactly what I address in Chap. 20, "Rewriting Trade Management." Would you like to learn how to use the MACD Histogram to confirm momentum trades? I'll cover how I do it in Chap. 22, "Placing Your Orders."

This book is a focused study on the specifics of trading the Forex market. There are plenty of other books that will give you definitions and descriptions. The trading community certainly doesn't need another one from me. I will only discuss the subjects I know inside out and only the strategies that I actually use. When you complete this book you will have learned my personal, step-by-step approach. No detail is hidden. You are "looking over my shoulder" as I explain how to trade the Forex markets. And I am honored that you are allowing me, if even for a short time, to be your teacher. I have learned from many teachers as I sought to become a successful trader. The ones that always taught me the most were the ones that showed me the market through their eyes and didn't try to be everything to everyone. It's that level of honesty that contributed the best of my education. I'm here to tell you that my style may not be your cup of tea. If you have that level of honesty with yourself you will go far in your efforts to become a trader. However, I do believe that many of you will find that the three-step approach taught in this book is a strategy that is easy to recognize and repeat. No matter how effective a strategy, if it can't be understood and followed, it is useless. I speak from experience. No one is born knowing how to trade; we all must begin the journey somewhere. If that's where you are now—beginning your journey into trading—I envy you. You are now embarking on an exciting journey that will teach you about the markets and about yourself. If you are an experienced trader seeking to learn more about the Forex market, welcome! Together we will be demystifying the foreign exchange and discussing a methodology you will be able to put to work as soon as you finish this book.

Let's begin!

CHAPTER 1

Trading ForeX

Trading ForeX

You may be asking yourself, "Why haven't I heard of this market before now?" If this trading market is relatively new to you, don't feel like you are alone.

Let's explore what every trader or investor needs to know about Forex. The foreign exchange or "Forex" (also called the spot market) is the largest market on the planet. This is an irrefutable fact. Its average $1.5 trillion to $2 trillion traded per day is almost 100 times that of the $25 billion of the NYSE. And while we will be discussing this in depth later, remember, size has its advantages.

The Forex market may seem like a new market to those of us in the United States but in actuality this market has been around for many years. There are two developments that brought Forex trading to life and to the United States. First was the decision that led to the free-floating market we trade today. The catalyst was President Richard M. Nixon's decision to abandon the gold standard in 1973. Subsequently, the fixed-rate system fell apart and currency values were set by supply and demand. Second was the Commodity Futures Modernization Act of 2000 approved by Congress on December 15, 2000, and signed into law by President William J. Clinton on December 21, 2000.

The Commodity Futures Modernization Act is a significant step forward for U.S. financial markets. This important law creates a flexible structure for regulation of futures trading, codifies an agreement between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission to repeal the 18-year-old ban on trading single stock futures and provides legal certainty for the over-the-counter derivatives markets.

Before late 1999, Foreign Exchange was largely unknown to the U.S. public because retail Forex brokerages simply did not exist in the numbers they do today nor were they regulated. The Commodity Futures Modernization Act allowed the CFTC (Commodity Futures Trading Commission) to regulate and oversee

the Forex Exchange brokerages. Subsequently, most Forex firms became members of the National Futures Association.

We now know that the Foreign Exchange isn't anything new, so why are we hearing so much about it now? As with many things in life and trading, it's all about timing. Once the Commodity Futures Modernization Act was passed, regulated retail brokerages starting popping up. With zero commissions they should have garnered some attention back in 1999–2000, but they didn't. Why? Well let me ask you, do you recall what was going on back in 1999? The U.S. stock market was three solid years into a rally, the likes of which cast a shadow on all other markets! Also a factor was the introduction of two very popular futures contracts. The Chicago Mercantile Exchange (CME) introduced the E-Mini S&P 500 and Nasdaq 100 contracts in September 1997 and June 1999, respectively. Consider that most futures traders were already familiar with well-established currency contracts traded through the CME and didn't know of the alternative. Subsequently, not a lot of people cared that the foreign exchange market was now regulated and retail brokers were ready to take orders online.

As with all cycles, what goes up must go down, and all great traders and investors never stop looking for a market to put their money into. The Foreign Exchange market offers the best trading hours (24-hours a day!), massive liquidity, no commissions, no margin calls, leverage, and no gaps. And if this wasn't enough, most brokerages will guarantee stop-loss orders. The only guaranteed stops I have seen were only in my dreams!

No Gaps and Guaranteed Stops.

There are no gaps in this market and stops are guaranteed. You may be wondering, "Did I read that correctly?" Yes, you did. Because the market doesn't have any gaps, you never have to deal with gap opens. The 24-hour trading and massive liquidity virtually guarantee that your stops will be executed without slippage. Although you should check with your brokerage, most firms offer this guarantee Sunday through Friday. As an experienced stock and futures trader I know better than to ask for that from my futures or stockbroker. The futures and stock markets simply can't offer traders this guarantee mainly because of limited trading hours that result in frequent gap opens.

For those of you who may be new to the concept of "gaps," a gap open occurs when a market opens higher or lower

than the last trading session's close resulting in a literal jump or "gap" in prices. Any stop-loss orders priced within this gap will not be executed at the stop-loss price but rather will become market orders at the next available price. Ouch!

24-Hour Accessibility and Liquidity

The Forex market is open 24 hours, six days a week, opening Sunday evening (EST) and closing Friday afternoon. Let's imagine waking up on Tuesday morning. While New York was sleeping, Sydney, Tokyo, Singapore, Hong Kong, Frankfurt, and London were all trading at various times. London is the most active time zone in the Forex and it is five hours ahead of New York. If New York is considered the center of the stock universe, then London is the center of the Forex universe. Since this is truly a global market, as one time zone finishes trading for the day, another is just beginning or already underway. News and short-term fundamentals have very little to no long-term impact because of the 24-hour, worldwide participation. News can be "digested" over time instead of being concentrated into a 71/2 hour trading session like the stock market.

There is no physical location where Forex is traded because it is an "interbank exchange" and is traded electronically through a network of banks, phones, and the Internet. Besides being open 24 hours a day, the Forex market is as large as it is because it is not located in a single city or exchange. In this way it differs greatly from the New York Stock Exchange or the Chicago Mercantile Exchange, both of which trade at a central exchange.

Diversify Your Approach and Portfolio.

Investing in stocks, bonds, and real estate are common ways to diversify a portfolio. Unfortunately, most people do not fully realize the benefits of including currencies to a portfolio. Think of currencies like the stock of a country. Currencies offer a market with high leverage and guaranteed stops. It is also a great market to diversify into because with just six U.S. dollar currency pairs to track, it isn't a time-consuming market to analyze.

Scandals, Manipulation, and News.

While I am a chartist (that means I believe that the news is built into the price action), I do acknowledge that reports can and do effect the Forex markets in the short term. Many times these economic events can be the catalyst of, for example, a breakout or pullback. However, because of the size of the Foreign Exchange market, the effects of news and

other outside influences are limited, quickly absorbed, and frankly, react in a more logical fashion. Think of it this way: If you had 10 people in a room and wanted to make them react a certain way to an idea or fact, it probably wouldn't be terribly difficult to change the minds of at least half or more. What if you wanted to do the same to 1,000 or 100,000? What about one million people? How effective would or could you be? Well the Forex trades $1.5 trillion to $2 trillion in currency a day, worldwide, 24 hours a day. This size alone makes it very difficult to manipulate. Even the well-documented Bank of Japan intervention had limited effect on the USD/JPY!

Currencies don't have accounting scandals or wayward CEOs. Consider that because the foreign exchange market is open 24 hours a day, each country can react to whatever relevant information is available at that time. This is precisely why the Forexreacts so logically to news and fundamentals. Many times economic and world events have already been factored into the market by the time New York opens. Because the market is continually open, starting in Sydney and moving on to Hong Kong, Tokyo, Singapore, Frankfurt, London, and New York, it allows the news to be digested by each time zone. Moving from one time zone to another "dilutes" any sudden or extreme reaction that is typically found in domestic markets where there is limited trading hours and where reactions are often exaggerated because many of the participants react to news or fundamentals all at one time.

CHAPTER 2

Getting Started

Getting Started

The market is one of the greatest teachers. It reveals itself to all of us each and every day if we are willing to pay attention. Too many times we try to box it, label it, or beat it.

In the end, all we need to do is study and measure it. With that end in mind, this book is predominately about the specific tools and strategies of trading. In fact, I kept a "sticky note" above my computer screen as I wrote reminding me of my goal: Write a book that could make me a trader again if I forgot everything I knew.

I endearingly labeled this endeavor to friends and family members as the "teach myself to trade from scratch if I got amnesia" book.

If you've been at this trading game for any length of time, you have undoubtedly bought many books. From my experience, most are what I have come to call "glossary education" books. These are those books that include a few paragraphs to a few pages on every conceivable pattern and indicator available, but no real methodology. It's full of definitions and explanations, but when you're through reading it you're no closer to a step-by-step methodology than you were before reading the book. It's the difference between general information and applicable knowledge.

And just in case I haven't made it abundantly clear, we're here seeking knowledge, my friends.

When I was first getting into trading I didn't know where to start. I had various mutual fund accounts and shares of IBM stock, which I wanted to trade using market timing. Mind you this was years before the Internet as we know it now. I would call my broker or look up quotes in the daily paper and plot the close by hand on my father's old engineering graph paper. Eventually I started trading commodities and I bought a subscription to a service that would mail me charts once a week that I could update by hand until the next set of charts were mailed to my home the following week.

As with many traders who become bored with end-of-day trading, I soon started active trading—"daytrading"—

and sought out intraday charts. So I ordered a service that delivered quotes and charts via satellite. One thing became clear in a hurry: high-tech tools weren't going to make me a trader; having a methodology was going to be the key.

My number-one problem was that I didn't have a methodology. Books on the subject of trading were not nearly as readily available as they are today. So I did the next best thing, I made phone calls to people that I thought could tell me how to get started. I was 17 years old and decided I would phone the people on my list of traders and make a donation to their favorite charity in their name if they would talk with me because I figured they wouldn't talk with a "kid" who was calling out of the blue. Funny enough, I think between my youth and unusual offer, everyone on my list took my call, most by appointment. They were generous with their time, many spending an hour or more answering questions. This time was invaluable but not for the reasons you would think, though.

None of them revealed some closely held secret to trading. (Matter of fact, in hindsight, many of them were actually portfolio managers and investors rather then traders, but it didn't matter.) They all shared one common while dispensing their advice: trade and risk management. Each of them, all in their own unique way, explained it wasn't so much how you got in the trade, but how you managed it that mattered. When discussing trade or risk management, they all had a set of steps they'd go through, beginning with a matrix of questions they'd asked themselves as they analyzed their positions. From these professionals, I learned the power of asking the right kind of questions when in a trade. Their time was invaluable to me and I am forever grateful to them. And whenever I have a chance to share my experience—successes and failures—I do what those people were gracious enough to do for me: offer my time generously.

After reviewing my notes from those conversations, I knew I needed a blueprint. A blueprint would allow me to "build a trade" the same way over and over again. It would allow me to use a set of tools in a consistent manner. I began to visualize myself as a "trading carpenter." My next problem was that after reading all the glossary books I could get my hands on, I was no closer to finding a set of specific tools that would answer the three questions all traders must ask themselves:

1. **Where to enter the market?**
2. **Where to set my profit targets?**
3. **Where to set my stop-loss?**

This book is dedicated to answering the above questions. It is important to know pertinent facts about the market you are trading, but if the information doesn't answer the three questions just mentioned, it is not helpful or necessary information. In my opinion, traders shouldn't concern themselves with much more than price action. **A chartist or technical trader believes that news is built into price action.** And it is with this philosophy that a chartist or technical trader can participate in any market as long as it is liquid. (A **liquid** market is a market that has enough volume to enter and exit quickly and without significant slippage.)

After reading this book, you will have learned a three-step formula to enter and exit the market, intraday and end-of-day. You will have a set of tools to consistently answer the three questions all traders must ask themselves. Most importantly, you will have a time-tested methodology using classic charting tools from which you can trade the Forex markets! *And let me share a little "secret" with you...I trade all markets this way: stocks, futures, and Forex!*

CHAPTER 3

History Repeats Itself

The Five Mistakes Traders and Investors Make

HISTORY REPEATS ITSELF: The Five Mistakes Traders and Investors Make

There are a number of different methods traders and investors have used to make money in the market. Ranging from fundamentals to technicals, tape reading to charting, the methods to success are as varied as the participants in the markets.

But we all tend to make the same dumb mistakes when we lose money. We're going to discuss the top five because without exception these mistakes are repeated over and over again like a skipping record we won't stop playing. So let's try and stop that cycle right here, right now.

Mistake #1: Trying to Pick Tops and Bottoms

I know what a rush it is to pick a top or bottom successfully. But if the goal of trading is to make money, then the adrenaline rush must be left to our more adventurous pursuits like skydiving and motorcycles. Trading against the trend is a high-risk approach. There are tools that I will teach you to use so that you know exactly where you are within the context of the trend. Even better, you will know when the market is directionless. Don't try to pick tops and bottoms in the market. Go learn to ride a motorcycle instead. It's more fun and less risky for your wallet.

Mistake #2: Not Selling a Losing Position

Have you heard these words before? "I can't get out now, I'm losing too much." Unrealized losses are still losses. Some losses are only temporary and within the parameters of the stop-loss, traders call it **heat**. Only you can decide what sort of heat you will take. The trades you choose to take will be based upon that tolerance. As traders we must distinguish between heat and losses that are losing trades that we refuse we accept, even when they have broken our stop-loss level. Before entering any trade, you

should know at exactly what price the trade becomes "valid"—this is your entry price. We should also know at what price the trade would become "invalid," and this is the level we love to move around: our stop-loss. Solid trade management is the only way to control the tendency of not adhering to your original stop-loss.

We must begin by defining price levels on the chart; we call these **decision levels**. At decisions levels we look to our trade management rules and put our thinking caps on. If we do not predefine decision levels we will be tempted to take action when it is not warranted. Decision levels allow us to time our actions for the right moment. More important, it also allows us to relax until that time that we need to make a decision. This is an important aspect of trading. We can't be focused all day, continuously. We'd burn out! Decision levels allow us to focus our attention to only those times where prices are alerting us potential entries and exits. This reminds me of something I once read about golfer, Tiger Woods. He was explaining how he manages his time and focus:

> My dad has always been a big believer in smelling the roses. I didn't understand that till I got older. It was his way of saying "Don't focus on the task too long or you'll burn yourself out." It was a great lesson, and it was also his way of saying the only real focus you should have is when you're getting ready to play the shot. Talk to your caddie; b.s.; talk to the crowd; look at other things. The game of golf is very beautiful; enjoy it.

I am going off on a slight tangent here, but it is something worthy of discussing as it gives us insight into how we handle the risks and rewards of trading. While I do not like to make comparisons between gambling and trading, there is one comparison that I think speaks volumes about the challenges a trader faces that a gambler does not. If we were to place a bet on a football game, we would do so before the game and then sit back and see what our choice brings. We can't change our bet at halftime or the fourth quarter. A football game has a start and finish. Conversely, a trade is a totally separate event. While the market has a definite open and close, a trade does not. We can change our mind, move our stop, and add to a winning or losing position. It's an event that has no beginning or end, unlike the football game. Because of this, trading poses completely different risk management issues and requires a

discipline level that events with a definite beginning and end do not.

Mistake #3: Getting Emotionally Involved in a Trade

This is the reason we don't sell a losing position. We take losses personally, we let our egos get involved, and we hate admitting that we are wrong. We tend to internalize market losses. Realizing a loss is a difficult step, there are five stages that are involved in accepting a loss, and we discuss each stage later in this book.

Mistake #4: Not Making Your Own Decisions

It's easy to be swayed by the news, CNBC, chat rooms, forums, etc. We begin to question our position or worse, we enter a trade based upon other people's opinions. The truth is it is a symptom of a much larger problem: not trusting your methodology. Rule #1 is that no one cares more about your money than you do. When we lack confidence, we give our decision power away hoping that someone or something else can help us. It's easy to understand why we tend to question ourselves. The same curious mind that wants to learn and got us into the market is the same mind that betrays us. Since there are always more indicators and strategies we're begin bombarded with on a daily basis, we wonder "Could that work better than what I have?" And off we go, buying new books, courses, software, and seminars. I've been there, too. I've got boxes full of courses and bookshelves staked with books to show for it.

I would be kidding you if I told you that I don't get curious about these things too! I attend seminars and enjoy them immensely. I read trading books from cover to cover. I get out and meet other traders. This is all because I now have the confidence to sit and listen to others without supplanting what has worked so well for me. I don't have to change my methodology, but I can add new distinctions from what I learn from other traders. It wasn't always this way... there was a time that I was easily swayed or would think I "needed" (more accurately, I "wanted") a particular piece of software or needed to change my style. My husband and I have a saying: "Need" is a funny word. What we think we need is typically what we really just want.

I remember many, many years ago when I was trading with a gentleman who wanted to use a mechanical system to trade about 40–50 stocks. He had been using a trend following system and it had been somewhat profitable for him.

This software was about $5,000.00 and enjoyed immense popularity in the late 90's... you know, when the market went straight up and (literally) chimpanzees were winning stock picking contests. He hired me to execute the trades since I was particularly good at order entry. And I have to admit the curiosity got to me... did this man know something I didn't? Could I be more profitable if I was a systems trader? I had never been a systems trader, and he was convinced he could make me one since I already knew so much about discretionary trading. For a couple weeks we did unbelievably well. I recall we were up about $90,000 midway through the first month. Of course, the voice of reason in my head was screaming, "You're doing well because the market is trending, dummy!"

So I went back to my partner and told him what I thought: *"We'll give back our profits when this market enters a trading range because this [trend following system] will whipsaw us by buying highs and selling lows in a chop. We'll notice when the market enters a trading range but the system won't... to it everything is a trend and it will continue to trade that way."* It fell on deaf ears, because by then this gentleman had calculated projections of what we would make if we continued at the pace we were going... forgetting that the market tends to chop about the same amount of time that it tends to trend. I don't think I lasted 30 days with my system trading partner, in fact I can't remember at all how we ended it. But I am eternally grateful for the lesson he inadvertently taught me. It wasn't that systems trading doesn't work—it does for some people—just not for me. He taught me what some fish find out too late: Every shiny, flashy object isn't a meal, sometimes it's a lure and that hook may land you in the frying pan.

So I returned to my home office and to the tools I understood well, tools that were well tested, and that I could use in a step-by-step manner day in and day out. I would not follow a "system" but rather become systematic. Doing this would allow me to follow a blueprint and "build a trade" in a consistent manner. To this day, any tools that I use must be able to answer the only three questions that are relevant in trading:

Where should I enter a market?
Where should I place my stop-loss?
Where should I place my profit targets?

Mistake #5: Putting All Your Eggs in One Basket

Diversifying is important for many reasons that you are probably already familiar with. Is it important to make sure that your portfolio is ready for good times

and bad, of course, and this means that a portfolio must be diversified into separate markets altogether. What I feel diversification does for a trader is this: It allows us to pick the best trade. If traders only watch a single market, they will tend to try to chase a trade or squeeze more out of a move than may really be there. If traders have alternatives, then they can sit back and let a trade come to them; they can wait for the best possible set up. This is what diversification does for a trader.

I was an avid S&P E-Mini trader for a couple years; in fact, there was a short time when that was all I traded. What a mistake that was! In a nutshell, I traded a high/low breakout method, and I found myself getting frustrated with the lack of breakouts and then a lack of follow-through if the market did manage to breakout. Because I wasn't looking at much else, I would begin to squeeze more out of a trade than it truly merited. Luckily, I snapped myself out of that fairly quickly without too much damage done. You know how sometimes your leg or arm falls asleep? Well my head feel asleep! The experience reminded me to not be lazy—to keep my pulse on the markets—so that when one market flat lines, I can transition to another. There are six major pairs that I will teach you to trade, and with six different markets to track you won't have to chase a trade, you can let the trade come to you. And remember, to diversify means that we add something new to our approach or portfolio, not replace something else that is working.

CHAPTER 4

The Major Players

The Major Players

Many people know the name George Soros as he is synonymous with currency trading. His legendary British pound trade that "broke the bank of England" is well documented.

But what if I told you that a major bank has made over $500 million trading Forex in a single year or that Warren Buffett has invested over $10 billion in currencies? What if I said to you that companies like Coca-Cola, Merck, Dell, Intel, Toyota, and Dow Chemicals all speculate in the Forex market?

Major banks and corporations trade the Forex. Many of the reasons for the size and liquidity of the Forex are the banks and corporations that participate in this market. This is not a new market, however, it is new to individual traders and investors in the United States. To a large degree, because of the Commodity Futures Modernization Act we now enjoy access to this Forex market. For years, though, banks and corporations have "secretly" participated and profited from this market. A few of the banks that are actively providing market liquidity are Credit Suisse, Bank of America, Goldman Sachs, and Morgan Stanley. Maybe you've heard of them. Corporations take participation in this market very seriously as many have in-house trading divisions or subsidiaries to handle their Forex trading.

Consider that only just over 5% of the activity is generated by companies and governments that do business in a foreign country and convert one currency to another to buy and sell goods and services. So what of the other 90-plus percent? Purely speculation! Because of its sheer size, there is little chance of market manipulation and a single insti-

tution dominating the Forex market. *It is for this very reason that the Forex markets adhere so well to charting and technical analysis!*

Even though there is no single dominating entity in the Forex market, there are some major players in this market, so let's discuss who they are. The Major Central Banks are responsible for monetary policy. The Federal Reserve, or the Fed is the central bank of the United States. The Bank of Canada or the BOC is the central bank of Canada and sets Canadian monetary policy. The ECB, or European Central Bank, is responsible for the monetary policy of countries in the European Monetary Union, or EMU. The Bank of England (BOE), the central bank of the United Kingdom, has total independence in setting monetary policy and its nine-member Monetary Policy Committee makes all decisions on interest rates. The Swiss National Bank or SNB, the central bank of Switzerland, is independent in setting exchange and monetary policy. The BOJ or Bank of Japan, is responsible for setting monetary policy in Japan. However, Japan's Ministry of Finance (MOF) controls all foreign exchange policy and therefore is still considered the most important monetary policymaker in Japan. Both the SNB and BOJ will affect their respective currencies by making remarks and intervening to enforce policy. Because Switzerland and Japan are export-driven countries, there is a preference for a weaker national currency.

Corporations have become increasingly more interested in the foreign exchange. The main cause is the rapid globalization of world economies. A multinational corporation often needs to make payment to another country, which means that many times they must exchange their "home" (or national) currency to that of the country they must pay. In doing so, they are now exposed to depreciation of they national currency. Therefore these corporations have become major players in foreign currency, as they must offset the risk of exchanging national currency for foreign currency. They must hedge against currency depreciation, which will put them on safer financial ground when they make future payments. But corporations do not limit themselves to simply hedging against currency depreciation. The number of corporations speculating in the Forex markets has increased, and with their activity and buying power, they have a continuing impact. However, because the nature of their trading or speculation involves primarily

hedging, they tend to take a longer-term approach.

If there is anything I want to impress upon you, it is this: The Forex is a heavily participated market for good reason. Many of the banks and corporations I mentioned earlier are actually making net profits from their speculation. Banks and corporations have had this "playground" to themselves for a long time. I want to encourage you to see why this has been the best kept secret *off* Wall Street.

CHAPTER 5

Prime Trading Times

Prime Trading Times

There are so many aspects of Forex trading that I find appealing: liquidity, leverage, strong trends, no commissions, only six pairs to have to track versus over two dozen commodity futures contracts and 40,000 stocks, no gaps, guaranteed stop-losses... but my favorite aspect of this market is that it is open 24 hours a day, six days a week.

It's said that ***the foreign exchange follows the sun around the world*** because as one country is closing for the day, another is just opening up.

During the stock market boom, many people didn't have the luxury of watching the market during the day, so active trading was typically ruled out. On the east coast, most folks were already at work before the market opened and returned home well after the market closed. The Forex market is different, it opens Sunday evening and closes Friday afternoon. It trades 24 hours a day with excellent liquidity. What does **liquidity** mean to a trader? It means that there is enough trading volume to assure that you will be able to get into a trade when you want to, but more importantly, you will be able to get out of a trade when you need to! This means that just about anyone can find a time that they can dedicate to Forex trading.

But what times are best? Even though Forex can be traded 24 hours a day, there are some times that are more liquid and better suited to particular currency pairs. The United Kingdom is the most active foreign exchange center followed by the United States, Japan, Singapore, China, Switzerland, Germany, France, and Canada.

Let's discuss the top three foreign exchange centers: The United Kingdom, Japan, and the United States. Together these three centers account for almost 70% of total foreign exchange trans-

actions. London trades, from 3 AM Eastern Standard Time (EST) to 11 AM. London is five hours ahead of New York. Since London is responsible for over 30% of all Forex transactions, most of the large market participants trade during these hours. Since most major reports in the United States are released between 8 AM and 10 AM EST, this overlaps with the already active trading in London and affords some excellent opportunities for those of us on the "other side of the pond." The most active pairs during London trading hours are the EUR/USD, JPY/USD, and the GBP/USD.

Between the hours of 8 AM and 5 PM EST, New York accounts for about 15% to 17% of Forex transactions. The U.S. market is active until about noon EST after which the volume will drop almost in half, due to London's close. This brings up an important aspect of foreign exchange: **market overlap**. The most active market overlap is the New York morning session and the U.K. afternoon. Keep in mind that home or national currency moves in sympathy with the equity markets of that nation, so the U.S. dollar will typically move with the equity markets.

Tokyo, despite it's diminishing role as an active foreign exchange center, still holds one important distinction: It's the first major market to open. Only about 10% of Forex transactions take place between Tokyo's trading hours from 7 PM to 3 AM EST. However, many market participants will use this time to get a pulse of the trading day and begin scaling into positions. The most active pairs are the JPY/USD and AUD/USD.

Fear and greed rule the markets so emotion creates motion, and by knowing when the different pairs are most active we can gain an edge by knowing when specific markets are most likely to be on the move. However, if you are not a night owl or an early riser, have no fear. The majors all rely on the U.S. dollar in part to value the pair so when the U.S. market is open the U.S. dollar and the equities markets will move one another so there are plenty of trading opportunities for those of us who like our beauty rest.

CHAPTER 6

Reading ForeX Quotes

Reading ForeX Quotes

When trading Forex, it is important to understand the price quotes. It may seem daunting at first, but I assure you it's easy to understand once you know what you are looking at.

First things first, the quotes are always presented in pairs. For example: the USD/CAD. This is the U.S. dollar versus Canadian dollar. Since the U.S. dollar is the first currency quoted in the pair it is known as the **base currency** and therefore has a value of 1. In other words *1* USD is equal to *x* CAD. If the current quote for the USD/CAD was 1.3910, that would mean that one U.S. dollar is worth 1.3910 Canadian dollars. Imagine flying to Canada, arriving at the airport and exchanging U.S. dollars for Canadian dollars. This would be a common example of the exchange rate.

There are six major currency pairs to watch. The U.S. dollar versus Japanese yen, U.S. dollar versus Swiss franc, U.S. dollar versus Canadian dollar, euro versus U.S. dollar, British pound versus U.S. dollar, Australian dollar versus U.S. dollar. The order in which the currency pairs are quoted is not interchangeable: They are fixed. These six pairs are called the "majors." The majors make up almost 90% of daily trading activity.

The first three—the USD/JPY, USD/CHF, and the USD/CAD—all have the U.S. dollar as the base currency and are quoted like the Canadian Dollar example above. The last three—the EUR/USD, GBP/USD, and the AUD/USD—all have the U.S. dollar as the second currency and are quoted differently. Since the first currency quoted in the pair is called the base currency, the second currency quoted in the pair is often referred to as the "second currency" or the "counter currency." When the U.S. dollar is the second currency in the pair, the quote is presented as *1* base currency equals *x* U.S. dollar. So in an example where the EUR/USD quote is 1.1858, *1* euro is worth 1.1858 U.S. dollars. Let's

return to the airport scenario. If you flew into a EMU (European Economic and Monetary Union) participating country like Spain and presented your U.S. dollars in exchange for euros, using the example of the EUR/USD quote at 1.1858, you would have to give 1.1858 in U.S. dollars for each euro.

Now I'm not one to get bogged down in facts and history but I find it helpful to know which countries adopted the euro. Twelve of the countries in the EMU adopted the euro (EUR). Those twelve are (in alphabetical order) Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Vatican City also adopted the euro. The euro is not to be confused with the ECU or European Currency Unit, which was actually a theoretical basket of currencies and not an actual currency as bank notes and coins never existed. The euro replaced the ECU concept.

It is when we turn to the charts that we can begin to visualize what the rates mean in terms of the trend. Let's return to the EUR/USD example. When this chart trends upward, it actually means that the euro is strengthening and the U.S. dollar is weakening. In other words, it takes more U.S. dollars to equal one euro. The same is true for the GBP/USD and AUD/USD.

When the U.S. dollar is the base currency (the first currency quoted in the pair) and the chart is in an uptrend, the U.S. dollar is strengthening and the Canadian dollar, Swiss franc, or Japanese yen is weakening. So in the example of the USD/CAD chart, if it is trending up, the U.S. dollar is strengthening and the Canadian dollar is weakening. If the chart is trending down, the U.S. dollar is weakening and the Canadian dollar is strengthening.

A **pip** (price interest point) is like a tick in the stock or futures market. It is the smallest increment of point movement. How do you find out which decimal place in the quote is the pip? Look at the number furthest to the right in the quote; typically it is the fourth decimal place. For example, in a EUR/USD quote of 1.1847, the 7 represents the decimal place that is the pip. So a price movement from 1.1847 to 1.1848 would be a one pip move. All the majors, with the exception of the USD/JPY, have four decimal places and the pip is the fourth decimal place. With the USD/JPY (U.S. dollar vs. Japanese yen), there are only two decimal places, and the second decimal place is the pip.

The pip dollar value is different for some majors. The dollar value for each pip in the EUR/USD, GBP/USD, and AUD/USD is a fixed $10.00. For the CAD/USD, CHF/USD, and JPY/USD,

it is not fixed, but rather fluctuates between $7 and $8.

What It Means to Trade in "Pairs"

Frankly, when I first began trading Forex it didn't really matter to me what "pairs" were. I had my charts and simply followed the trends and retracements, and that served me very well. It was just like when I was trading stocks back in the Internet heyday. It didn't matter much to me what the companies did just as long as there was good volume and a reasonable bid/ask spread.

It didn't take very long for Forex to become a larger part of my daily activity and I thought it prudent to learn more about these pairs and the relationship between the two currencies that made the pairs. Since I traded only the "major" or the U.S. dollar pairs, I knew I would have to watch a total of six pairs: the EUR/USD, USD/JPY, GBP/USD, USD/CHF, USD/CAD, and USD/AUD. The reason Forex is traded in pairs is because we are trading the exchange rate between two currencies. An **exchange rate** is the value of one currency against another.

Let's take the EUR/USD, for example. The EUR is the base currency, and the USD is the second or counter currency. If I am buying the EUR/USD pair, exchange rate tells me how much I have to pay in U.S. dollars to buy one euro. If the current quote on the EUR/USD is 1.2300, I would have to pay 1.23 U.S. dollars for one euro. If the U.S. dollar is the base currency, as in the USD/CAD, the exchange rate tells me how much I have to pay in Canadian dollars to buy one U.S. dollar.

When we are trading, we should think of the base currency as the main unit of your buy or sell. So if I were to buy the EUR/USD, I am simultaneously buying the euro (the base currency in this pair) and selling the U.S. dollar (the second currency). When I buy that pair I believe the euro will increase in value versus the U.S. dollar.

If I were to sell the EUR/USD, I am simultaneously selling the euro and buying the U.S. dollar, which means that I believe that the U.S. dollar will increase in value versus the euro. So now I hope you understand what it means to trade in pairs.

CHAPTER 7

Tools of the Trading Game

Tools of the Trading Game

There are two decisions that I credit my trading success to. I've found that the decisions we make early on in any endeavor shape the final outcome.

For some fortunate reason, I decided early on when I was designing my blueprint that I would only use "objective tools" that could project specific price levels on the chart that would serve as entry and exit points. Objective tools are not subject to artful interpretation. A trendline is broken or it is not; an indicator is either showing strength, weakness, or it's neutral. I also decided that I wanted my entries and exits to be established well before I entered the trade, and I wanted these points to be relevant to the price chart and not some set number of points or percentage. Deciding valid risk and reward ratios based upon the price chart was the most important idea that I built into my blueprint. Think about it... *does the market really care that I have set a two-point stop-loss or that I only want to risk 3% on a trade? Does it matter if I want to make $400 on the trade?* Do these arbitrary numbers have any bearing at all on price action or on support and resistance levels on the price chart? You and I both know it does not.

Support and resistance are the most powerful tools I use to decide my entry and exit levels. There are many types of support and resistance: uptrends, downtrends, psychological price levels (or round numbers), moving averages, and Fibonacci Levels. Even though this book is about trading Forex, these tools and blueprint will work on any market or timeframe. And this is due to the nature of the tools: they are universal and robust. Which is simply "system-speak" for the fact that they will work well all on any market and they work consistently. Here's another piece of advice: Be wary of any trading system or tool that only works on specific markets or a specific timeframe. As long as a market is liquid, the tools I am describing will work for you.

Another point worth mentioning was a conscious decision on my part not

to rely on indicators for entries and exits. Indicators are to be used as confirmation tools. Since my setups rely on price and chart patterns, it's as easy as glancing at the indicator and taking a quick read on whether it confirms what my price or chart pattern set up is showing. Remember, indicators are all calculated by some combination of adding, subtracting, multiplying, and dividing the market's open, high, low, and close. Because of this, indicators will always lag price action. Indicators can be very helpful, though. I use what I have come to call "on/off indicators," as I only want to use indicators that clearly show buy, sell, or hold without having to determine whether a specific hook or cross has been made.

An on/off indicator can be simply defined as any indicator in which you can take a reading that tells you to buy, sell, or hold. It is does not require that you recognize some sort of hook, cross, pattern, count bars, or any other nonsense that I have seen. You should be able to define an on/off indicator by telling someone who knows nothing about trading that prices are either—*for example*—trading above or below a Moving Average or that the CCI (Commodity Channel Index) is plotting below the –100 or above the +100 level or that a MACD histogram is above or below the zero or signal line.

Keeping it simple with support and resistance, Fibonacci Levels, moving averages and on/off indicators in hand, I set out to build my step-by-step blueprint. The goal of trading is to find a methodology that will put you in the trade at the right time and more important, take you out of the trade at the right time. Even with that said, if the methodology is not easy to recognize, react to, and repeatable, it doesn't matter how good it is. The tools must be applicable! Furthermore, if you don't understand why and how I use the tools, it won't much matter because throughout this book my goal is to give you the confidence that you can trade successfully with these tools. So let's begin by discussing each tool in detail.

CHAPTER 8

How to Draw Trendlines

How to Draw Trendlines

You've undoubtedly heard of markets that are in an uptrend or downtrend, and we understand that this is a description of the general direction of the market.

But how do we measure it? *We use trendlines.* Trendlines let us know the direction of the trend, the strength of the trend, and also when that trend may break.

Personally, I love trendlines. I spent a lot of years trying to become a "sophisticated" trader. As you get a better at your career you develop a higher, and often, more complicated level of skills. Right? Well, I learned how wrong that could be. In my effort to become a "better" trader all I did was complicate a relatively straightforward endeavor: locate the trend, measure the strength of the trend, project the potential reversals within the trend. So I abandoned my "sophistication" and returned to the tools that I first learned to use when I began teaching myself how to trade. Sometimes we search too hard for answers that are right in front of us.

Grab a ruler, connect at least two swing lows or swing highs on your chart, and what you have is a trendline! We mark trendlines by drawing a straight line connecting the swings or pivots of the market, much like "connect the dot." A **swing (or pivot)** is a previous high or low where the market reverses. They are the peaks and valleys that can be seen on a chart (Ch 8.1). *And by the way, the three lines you see moving in unison across the chart is called the Wave. You'll learn about this tool in Chapter 11, Visual Tools.*

An **uptrend line** is a straight line that is drawn connecting the valleys or swing lows of a market that is rising. We need at least two swings to connect. The swing lows are also considered support levels. **Support** is best described as a "floor." It's an area where prices stabilize and then move up from. Buyers represent support or the "floor." When buyers feel prices are a value or under-priced, they step in and buy and therefore support the market. Support can be both a diagonal line as in an uptrend or a horizontal level.

There are at least two swing lows that were connected to draw this horizontal support level (Ch 8.2). I draw my trendlines from previous swing highs or swing lows then extend these straight lines beyond the current candle or bar. This allows me to project where support or resistance may develop in the future.

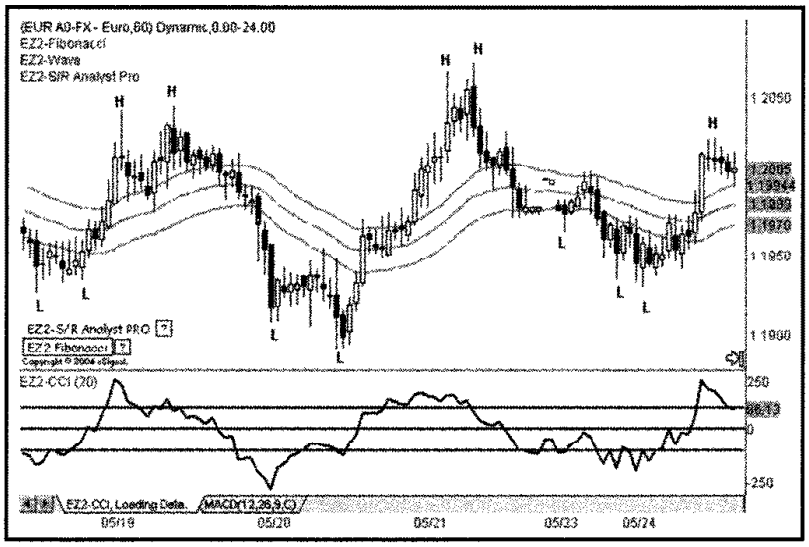

Chart 8.1

Notice that there is more than one uptrend line drawn on the chart (Ch 8.3). In this case we can see there are three: two minor uptrends and one major uptrend. (The major line is designated by the thicker line width) There can be more than one set of trendlines on a chart since support and resistance can develop at more than one level. Frequently we will see both uptrends and downtrends on a chart and this occurrence will typically happen when the market is trading in a range or consolidating.

A word about trendlines: Notice that the major trendlines on the chart have two points that were connected to form the line. These two points are almost four days apart on this 60-minute chart. The two minor trendlines have points that

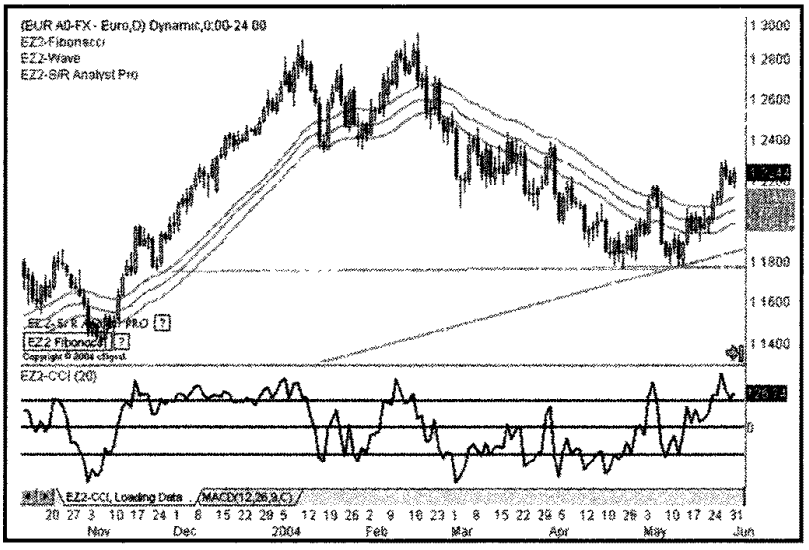

Chart 8.2

are less than a half-day apart. One of the questions that commonly comes up when drawing trendlines, support, and resistance, is how far to look back when choosing swing highs and swings lows to connect, referred to as the look back. The **look back** is how many trading days, candles, or bars we will go back in order to find these swings. I will typically use a look back of one month to two weeks for intraday charts and one year for end-of-day charts. We know we need a minimum of two swings or "touch-points" to connect. We use the 30-minute, 60-minute, 180-minute, 240-minute, and the daily charts for our trading and this translates into the following lookback:

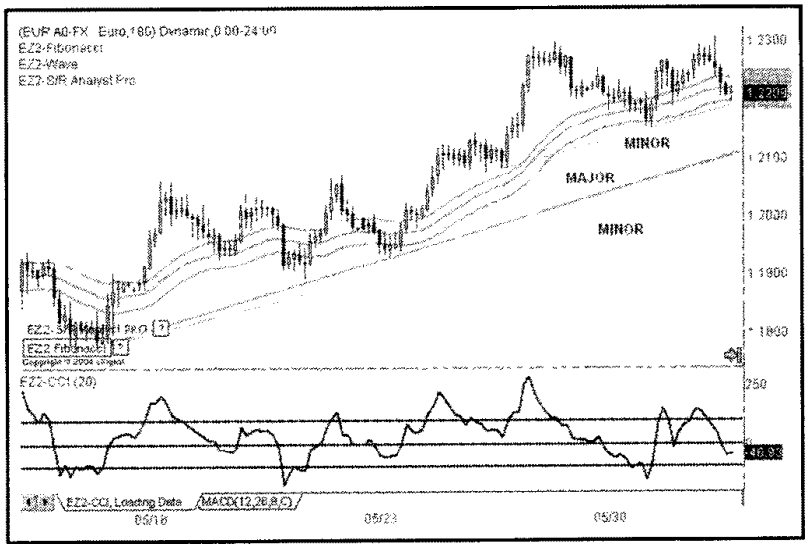

Chart 8.3

- The daily is the easiest to calculate because it means we are going back one year, or approximately 240 trading days.
- The 240-minute chart goes back one month, or 20 trading days, which equals 120 lookback candles or bars.
- The 180-minute chart goes back 20 trading days, which equals 160 lookback candles or bars
- The 60-minute chart goes back two weeks, or 10 trading days which equals 240 lookback candles or bars
- The 30 minute chart goes back 10 trading days, which equals 480 lookback candles or bars

These are just guidelines that allow us to not get caught up in going too far back or using price action that is too recent. For long-term timeframes like the daily or end-of-day chart, the market's memory is about one year. For intermediate term timeframes like the 240-and 180-minute charts, it is 20 trading days or one month. For short term timeframes like the 60- and 30-minute charts, it is 10 trading days, or two weeks. Now that we have learned how to focus on the most rele-

vant price action of a chart, let's continue with more chart patterns that are made with trendlines, support, and resistance.

A **trading range** develops when prices bounce off both a horizontal support and horizontal resistance level. If an uptrend is a consistent increase in price and a downtrend is a consistent decrease in price, then a trading range is a battle between buyers and sellers. It is also sometimes referred to as a narrow sideways channel or **rectangle**, which is an excellent description of what it looks like on a chart.

Consolidation develops when prices begin to trade in a progressively narrower range. As the range narrows, the support and resistance tighten. Typically a consolidation will have an uptrend line and downtrend line forming at the same time, which is commonly referred to as a pennant or **symmetrical triangle**. However, consolidation can also develop with a horizontal support level and downtrend line or a horizontal resistance level and uptrend line. These are called **asymmetrical triangles** (Ch 8.4).

A **downtrend line** is a straight line that is drawn connecting the peaks or swing highs of a market that is falling. The swing highs are also resistance levels. If support is described as a floor, then **resistance** is best described as a ceiling. It's a price area that prices level off at and then move down from. Sellers represent resistance or the ceiling. When sellers feel prices are too high or overvalued, they sell and therefore prevent the market from trading higher. Resistance can be both a diagonal line as in a downtrend or a horizontal line.

While you will hear a common description of uptrends as a series of higher highs and higher lows, it is really just a series of higher lows or support!

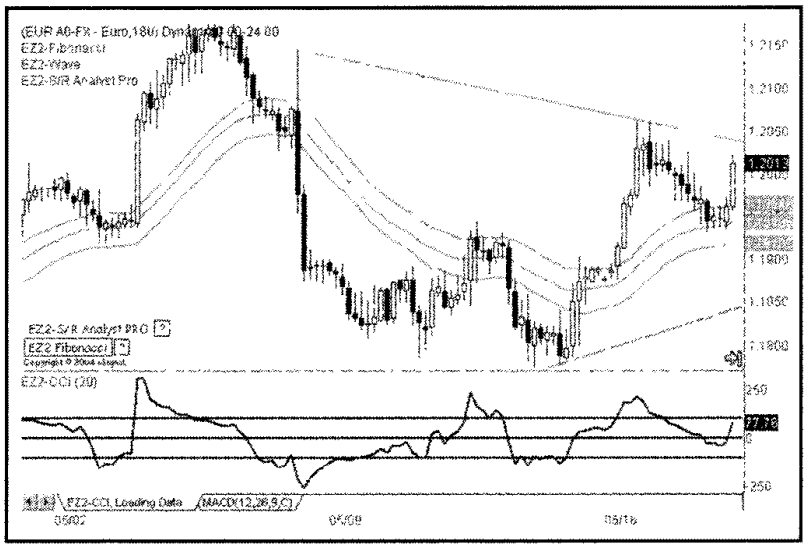

Chart 8.4

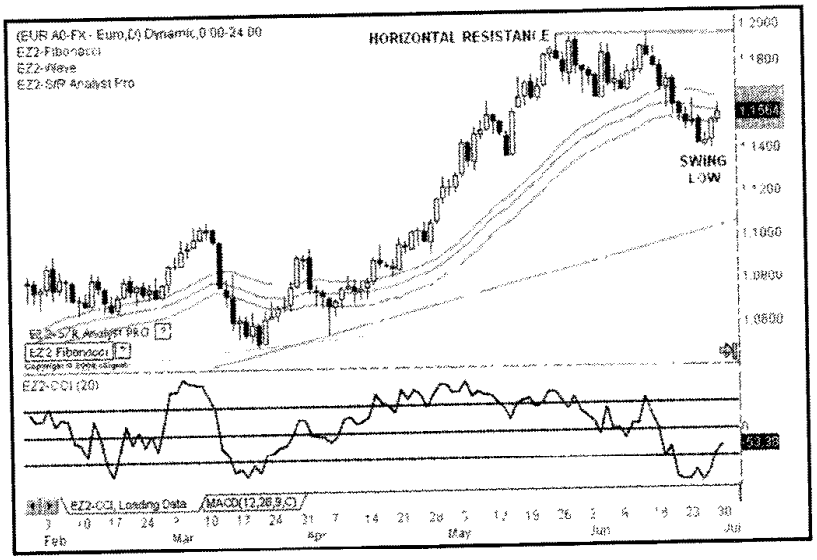

Chart 8.5

The same holds true for downtrends, the definition of which is a series of lower highs and lower lows. Again, all that a downtrend really consists of is a series of lower highs or resistance. These are important distinctions because when trading trendlines we wait for breakouts or breakdowns. **Breakouts** occur when prices trade up through a resistance level like a downtrend line or horizontal resistance level. **Breakdowns** occur when prices trade down through an uptrend line or horizontal support level.

What we can see from the support and resistance on this chart is that the market was trading higher and then became overvalued (Ch 8.5). Sellers then stepped in creating resistance, in this case the horizontal level. The market then sold off to a small degree and found some buyers as evident by the most recent swing low.

Just as we can trade breakouts and breakdowns from trendlines, we can use "hits" off support and resistance. Fibonacci levels are also support and resistance (Ch 8.6). A hit can be described as when prices reach an established resistance or support level, and turn in the opposite direction. *Think of a ball bouncing.* A hit off a resistance level would be shown as prices trading upwards to a ceiling only to find sellers at that level and then trade lower from there. If this level is approached and rejected a number of times (at very least once before, preferably twice) we should draw a line at this level, which we will then call resistance.

Many of you are familiar with chart patterns. You may be familiar with channels, triangles, head and shoulders, wedges, and pennants. These are all just different formations of support, resis-

tance, uptrends, and downtrends. The reason I make this distinction is because that's the way I taught myself to find patterns and also because I noticed a particularly interesting phenomenon early on when I begin teaching.

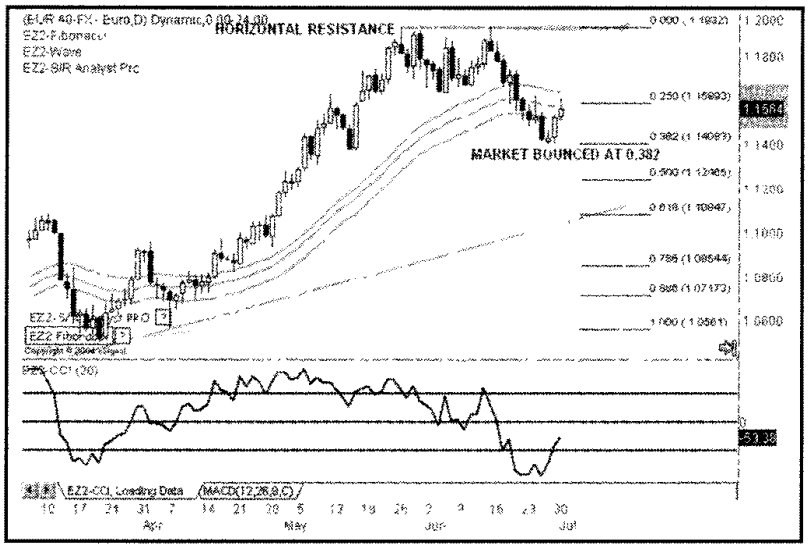

Chart 8.6

When I would teach a lesson on, for example, triangles, I noticed that suddenly students would notice triangles everywhere. Whatever they were charting, there was a triangle, *whether it was there or not!* It finally dawned on me that with a new way to view the charts, they would inevitably find only what existed in their knowledge base. Of course, what else could they refer to? Their minds were on triangles because I gave them a new concept with which to view the chart. It reminded me of something that I heard a first-year medical student do. Whether it's true or not, I don't know, but it's an interesting study in human behavior. First-year medical students learn about disorders and diseases and the symptoms of each. As they learn of these symptoms, they will tend to view any symptom they notice to be those diseases they study about, no matter how rare or unlikely. You see? That's the framework or the "mental matrix" by which they process information. And as traders, we're the same way. So rather than learning each chart pattern individually, it is best to understand what support, resistance, uptrend, or downtrend lines combine to make each chart pattern first. In that way, there are no limitations to what we will see, and we will not force the patterns onto the chart.

Many times you will come face to face with a chart that has more than one chart pattern forming on it. Take a look at this chart of the euro on a daily chart. We have lines and levels forming a side-

ways narrow channel or rectangle, a symmetrical triangle (or "pennant"), and two asymmetrical triangles all on the same daily chart (Ch 8.7)!

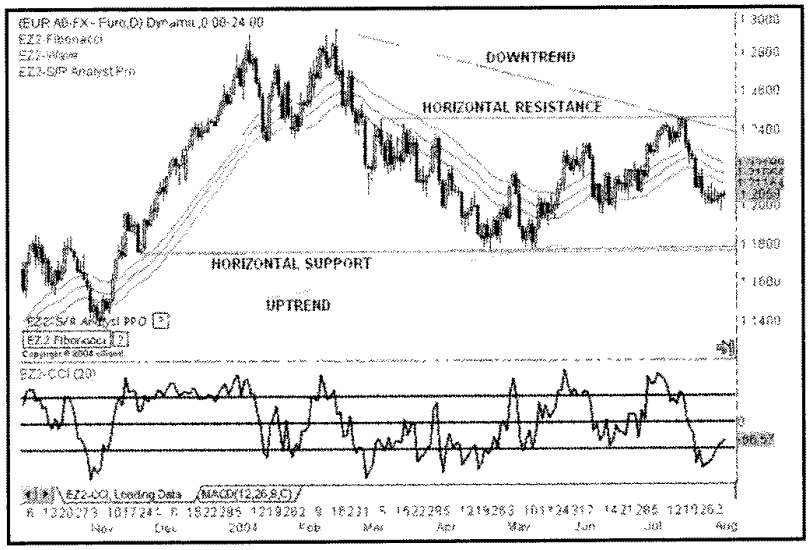

Chart 8.7

In these situations, traders can pick and choose which setup suits their risk tolerance and which formation they feel more comfortable trading. I approach these common situations by typically taking the first breakout or breakdown level because we are definitely looking for a momentum trade setup. However, an effective option I will frequently employ would be to use any relevant Fibonacci levels, if available. When there is a breakout/ breakdown level that coincides a Fibonacci Level, you have excellent confirmation. *Be on the lookout for anytime you can use this confirmation!*

Another common view of multiple lines and levels occurs when we have more than one set of uptrends and downtrends creating a symmetrical triangle. I will treat these setups the same way as when I have multiple patterns forming (Ch 8.8).

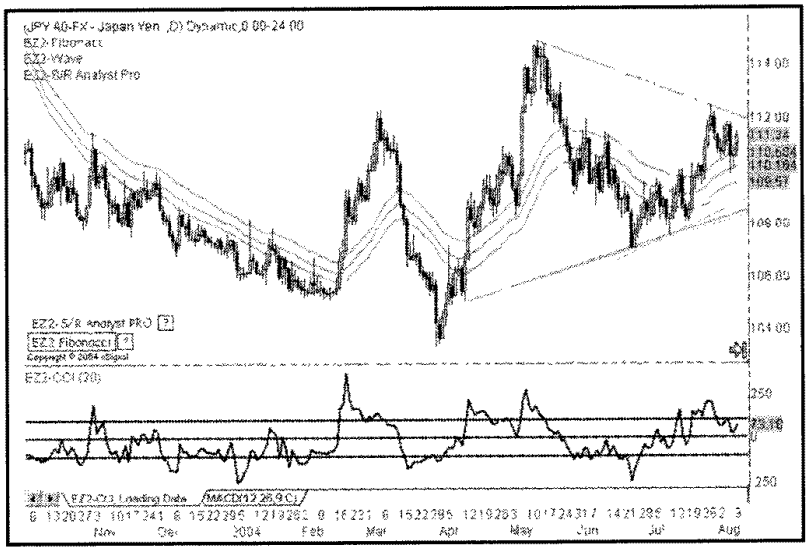

Chart 8.8

Rallies and sell-offs can also be measured and predicted! And much like how we have now learned to draw support and resistance, uptrends, and downtrends, we can also draw retracement levels.

Imagine that you are waiting to enter the market if prices trade above the downtrend or prices trade below the uptrend (Ch 8.8). *Where would you place your profit target? How far is the market most likely to go before it bounces?* Once you learn to draw Fibonacci levels you will see how precisely you will be able answer these questions!

CHAPTER 9

The Difference Between Major and Minor Trendlines

The Difference Between Major and Minor Trendlines

We've spent some time discussing not just trendlines, but major and minor trendlines. I mark major trendlines with a thicker line width than minor trendlines.

Even though both types of trendlines can confirm a breakout or breakdown, we place more importance on the major trendlines. Here's how I differentiate between the two:

Each trendline is assigned a score based upon four criteria: total length, number of touchpoints, continuity of touchpoints, and proximity to current price. I am not literally taking score; rather I am comparing the available trendlines to one another. I am looking to see how long the trendline is from the first touchpoint to the last. I am counting how many total touchpoints make up the trendline. I am looking for gaps, or major and sudden rallies, and sell-offs. Finally I want to see how close the trendline is to current prices. The trendline that has the highest overall score (based upon the relative weighting of the four criteria) will be drawn thicker and thus be a major uptrend or downtrend line.

If you look at the two uptrends on the CAD A0-FX daily chart (Ch 9.1), you'll see we have one major uptrend and one minor uptrend. If we begin analyzing the lines with the four criteria, we can begin to make the distinction between a major and minor line. *It's a comparative analysis.* In other words, it depends upon the other trendlines on the chart and how they score with the four criteria. The major uptrend line on the chart has three touch points that connect it: January '04, March '04, and April '04. The fact that there are a total of three touchpoints (number of touchpoints criteria), and that the first two were three months apart (total length criteria), help make it a major trendline in comparison to the minor trendline. It is also closer to current price, so it scores better on the proximity comparison. The minor uptrend line has its first touchpoint also in January '04 and a second touchpoint

in April '04 for a total of two touchpoints. The time frame between each touchpoint is certainly as long as the major trendline. The reasons that the separate the two are:

1. The major trendline has a total of three touchpoints.
2. It is also closer to current price when compared to the minor trendline.

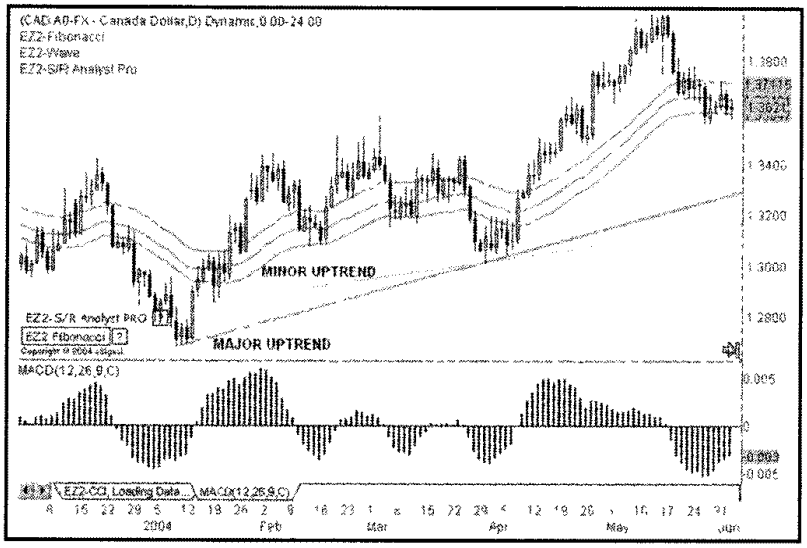

Chart 9.1

CHAPTER 10

Fibonacci Levels

Fibonacci Levels

Most of us initially get into the trading game as a way to improve and take control of our financial lives.

Let's discuss a rule that I live by:

My tools must answer the three questions I ask myself when setting up a trade:

(1) Where to enter the market?
(2) Where to set my profit targets?
(3) Where to set my stop-loss?

Listen to me now; believe me later. From experience I can tell you that the market has taught me this fact, ruthlessly.

Most of us initially get into the trading game as a way to improve and take control of our financial lives. Sooner or later though it becomes all-consuming to see just how good we can be! If you're anything like me, you're either already totally addicted to the market... or you will be. And then we're off to the races to find the best system, tools, indicators, books, videos, software—you name it—that will reveal the secret to trading. Some of you may have already gone down that slippery slope; others have just begun. *We all do it.* My mom repeatedly told me while growing up me that smart people will learn from their own mistakes but wise people will learn from other people's mistakes. The Holy Grail doesn't exist. At least not the way we think it does.

Here's the "secret" to successful trading: Use time-tested tools consistently with sound trade and risk management. *That's it.* The market is very much a natural phenomenon in that it is a reflection of our fear, greed, and emotion. Since human behavior can be studied and predicted to a fairly accurate degree, so can the behavior of the markets. How many times have you said to someone, "I knew you were going to do that!"? More often than not... that's how the market is too.

One of the best trading tools I use is a mathematical formula discovered by a man named Leonardo da Pisa, *aka* Fibonacci. A scientist and mathematician, Fibonacci was not seeking how to better trade the markets because it did not exist in his lifetime. Born in 1175 AD, he is best known for a series of numbers, later named Fibonacci numbers. The numbers occurred so frequently in nature that the series is commonly referred to as a law of nature. While it is not really a law, it is at very least a very strong tendency.

Fibonacci numbers can be used to explain the number of petals on a flower, the spirals of a nautilus shell, the bumps on a pineapple, the scales of an acorn, the incline of the Egyptian pyramids, even the rate at which cells multiply. Geometry, architecture, and nature all share a tendency to act and react within the mathematical framework of Fibonacci numbers. Since human beings are part of nature, and the financial markets are a reflection of human behavior, we can track the ebb and flow of the markets with Fibonacci numbers.

So what does this have to do with trading Forex? *Glad you asked.* Starting with zero and one, then adding the last number to the sum of the previous two numbers to get the next number forms the Fibonacci number series.

0 + 1 (last number) = 1 (sum)
1 + 1 = 2
1 + 2 = 3
3 + 2 = 5
and so on until you get the string
0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144...

For trading purposes we use the values derived by dividing the numbers next to each other in the string by their sum. Those values create the following Fibonacci retracement and extension levels that traders have come to commonly use:

0.250, 0.382, 0.500, 0.618, 0.886, 0.786, 1.000, 1.272, 1.618, 1.886

Fibonacci levels from 0.000 to 1.000 are called **retracements**. The levels above the 1.000 level are called **extensions** as they extend beyond 1.000, or a "full retracement."

Now that we know what retracements and extensions are, let's get to some practical application of these levels. As traders, we must be able to identify and react to retracements levels, which are pullbacks or bounces within the movement of a market. **Pullbacks** and **bounces** occur after a market has made a

rally or sell-off. Profit taking most often creates a correction on the chart, and if it occurs within an uptrend, it is called a *pullback*. If it occurs within a downtrend, it is called a *bounce*. The levels at which pullbacks and bounces occur will be the price levels at which we can take profits, place our stop-loss, or even confirm entries. Furthermore, knowing where these levels are before we place a trade allows us to plan ahead and decide risk/reward ratios; this is the vital step of determining whether we will take the trade in the first place.

Note: There is no shortage of charting platforms. Most charting platforms will allow you to draw retracement and extensions and do the calculations for you. They are as easy to draw as finding the two swings you would like to connect using a drag and drop tool to find the Fibonacci levels. I personally use eSignal because it allows me to add the Fibonacci numbers I would like to use, draw multiple levels, and easily delete levels I do not want to use.

Fibonacci retracement and extension levels can show us price levels that we may employ to enter or exit the market; moreover, they can confirm breakouts and breakdowns. Fibonacci retracement and extension levels are really just support and resistance. When a market begins to bounce from a significant decline or pullback from a major rally, the prices will do so most often at Fibonacci numbers. These levels are the retracement of the most recent trend, or last major move. The **last major move** can be measured from the recent swing high to recent swing low. This would be a purely visual way of measuring, much like the peaks and valleys we would use when drawing trendlines, support, and resistance. However, Fibonacci retracement and extension levels are probably not more widely used because of the perception that drawing these levels can be difficult. There is a lot of confusion and misinformation when it comes to how to draw these levels or finding the last major move. The first rule of trading is to be able to see the whole picture. If you use the *look back* settings we use when drawing trendlines to view the most relevant block of time on the chart, the significant swings from which you can begin drawing Fibonacci retracement and extension levels will become obvious. Another key to success when drawing Fibonacci retracement and extension levels is to draw a couple of them and get a feel for how they look. In other words, try a few different swing high and low points. There are always multiple Fibonacci retracement and extension

levels on a chart. The common misconception is that there is a right one. All we are looking for is the most relevant and recent. The most relevant Fibonacci retracement and extension level will have secondary confirmation. It will coordinate with breakout and breakdown levels, it will line up with other support and resistance levels, "psychological," or round numbers, etc. Until you are able to train your eyes to see these accurately and easily, let's explore another way of finding swings with a simple chart pattern: minor highs and minor lows.

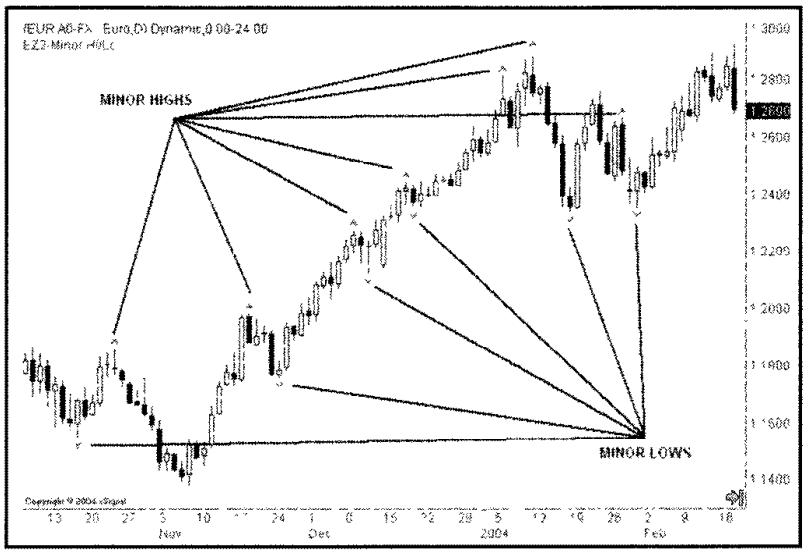

Chart 10.1

Finding Minor Highs and Minor Lows

Minor highs and minor lows are not complex patterns. (These are not to be confused with swings or pivots as minor highs and minor lows have a specific chart pattern that must form.) With a little practice, minor highs and minor lows will seem to pop out of your charts. Because an uptrend is a series of higher lows and a downtrend is a series of lower highs, I find that minor highs and minor lows identify the individual highs and lows within the overall trend (Ch 10.1). Consider this: An uptrend is simply support, while a downtrend is resistance.

The concept of minor highs and minor lows is certainly nothing new. I first began testing these patterns when I read about them back in late 1989. When looking for a minor high, you are looking for a current high that has a lower high before and after it. Minor lows occur when a current low has a higher low before and after it. These patterns show us where prices are likely to change direction as in a swing or pivot. Often you will see there are minor highs and minor lows in close proximity to one another on the chart. In situations like these, simply use the highest minor high or the lowest minor low.

Minor high and minor low patterns consist of three candles, end-of-day or intraday. Ignore inside ranges. (Inside ranges, also known as "inside days," are those candles whose trading range is within the previous day's range.) Let's take a look at the circled section of this daily chart of the euro (Ch 10.2A).

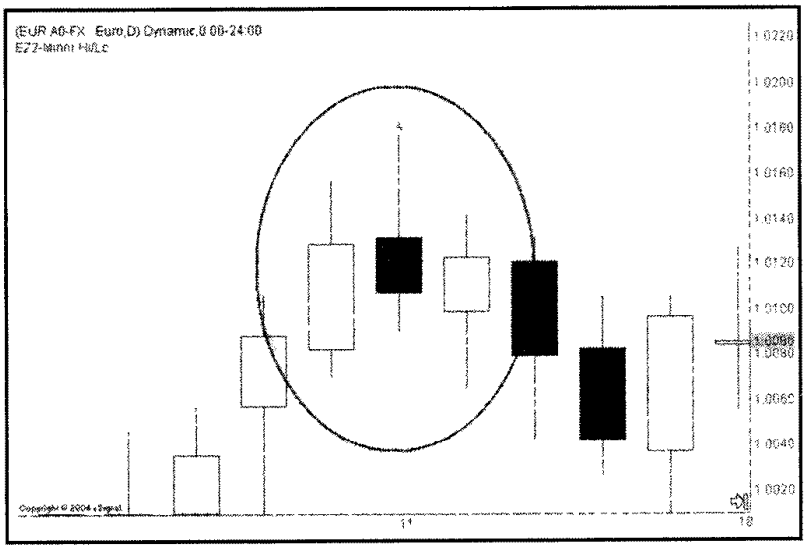

Chart 10.2A

As you can see, we were alerted to this minor high because prices first established a new high, marked by the carrot symbol above that candle's high. Once we establish a new high, we go back to the preceding candle to see whether it had a lower high and lower low. If it did, that is day 1 of your pattern, and the new high is day 2. Next we need to see a day 3 candle that has a lower high and lower low compared to the range of day 2. If we do, we have a confirmed minor high (Ch. 10.2B).

With these minor highs and minor lows we can begin to draw Fibonacci retracement and extension levels because we have all the high and low pivots marked on the chart with a specific criteria. These highs and lows lay out the last major moves.

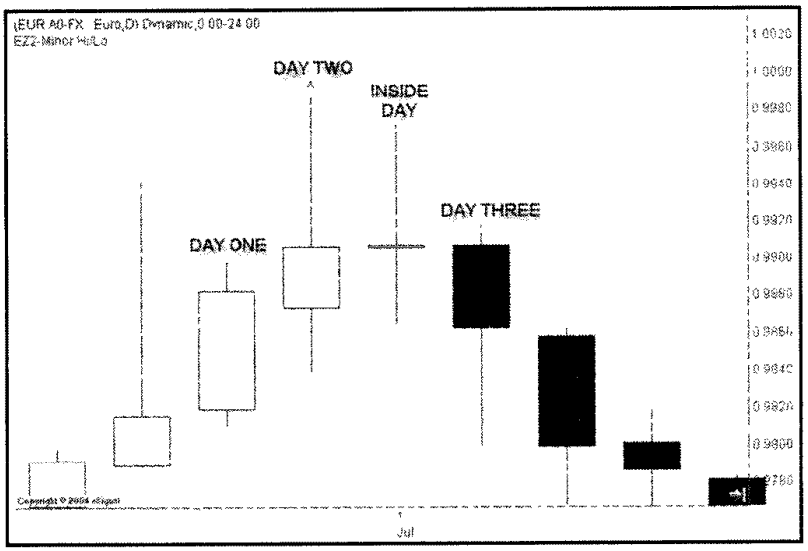

Chart 10.2B

Since we are looking for the "last major move," which is the most recent rally or decline, we will focus on the move from the highest, most recent minor high to the lowest, most recent minor low.

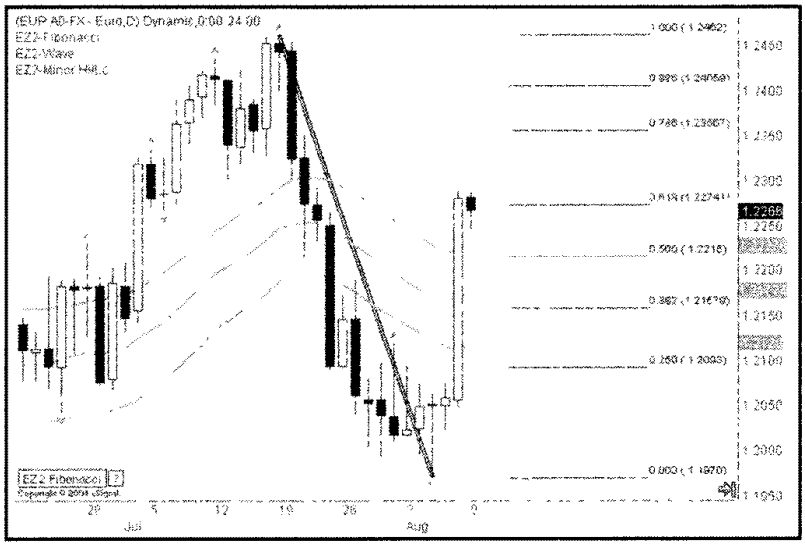

Chart 10.3

The pattern will take on a slightly different look when there is an inside day, but the concept is still the same. Our goal is the find the reversals of trend that make up a "last major move" which is simply an un-retraced rally or sell-off (Ch 10.2B). Once you have drawn your Fibonacci levels based upon the last major move, you will see that you now have support and resistance levels that will help you determine where the market is most likely to move to next. Remember that if you are looking for upside resistance, you are looking for the last major sell-off and if you are looking for downside support, you are looking for the last major rally (Ch 10.3). Personally, I think of Fibonacci levels as the mathematical explanation of the saying that for every action there is an opposite reaction.

There are other ways of locating swings or pivots. And while the definitions may differ from trader to trader, you can use a point-based measurement or even a percentage-based measurement. One simple way would be to find new highs that are followed by two subsequent lower closes or new lows that are followed by two subsequent higher closes. The high or low createdwould qualify as a pivot or swing. Whatever way you decide to begin finding swing highs and swing lows from which to draw your Fibonacci levels, just remember that the best way to learn is to practice, practice, practice!

CHAPTER 11

Visual Tools

Visual Tools

I'm going to now share with you how I use those trio of lines traveling across my charts. From my experience, teaching students from different countries, backgrounds, and education levels, I have found that most of us are visual traders.

What we *see* resonates with us and shapes our opinion of the market. It makes perfect sense. We believe what we see. Charts are visual tools, and much of what we do as we learn to become better traders is train our eyes to notice the small clues the market gives us.

Some of my favorite tools have come from working closely with my students. I love teaching and for a very self-serving reason: It makes me stick to my own rules. I have to walk the talk. I think my students can sniff-out a trader from a wanna-be trader a mile away. I teach using real time charts. If students can see how the setup develops in real time, make the decisions that have to be made in real time, and feel the ebb and flow of the market, they then can begin to understand what it takes to become a trader.

I encourage my students to think outside the box and come to me with ideas they would like to experiment with. Once such an idea came from a student, Dave, who is now a very good friend. I respected Dave's dedication as a student immensely. And now I respect him for being a dedicated trader. I like Dave's take on the world and the markets. So when he came to me about four years ago with a moving average he was trading with, I listened. He was playing with some Fibonacci number-based moving averages, specifically, the 34 EMA. (EMA stands for exponential moving average.) Moving averages (MA) are very popular technical analysis tools that not only smoothe out the major trend in the market but also show support and resistance. Simple MAs calculate and plot the average of a set

number of days or periods. For example, a 20-day MA will take the last 20 closing prices and divide them by 20 to plot the average. Moving averages can be calculated for any intraday time frames (e.g. 5, 10, 20 minutes) and also on either the open, high, low, or close. Exponential MAs work much the same way except that they place more emphasis on more recent prices to plot the average.

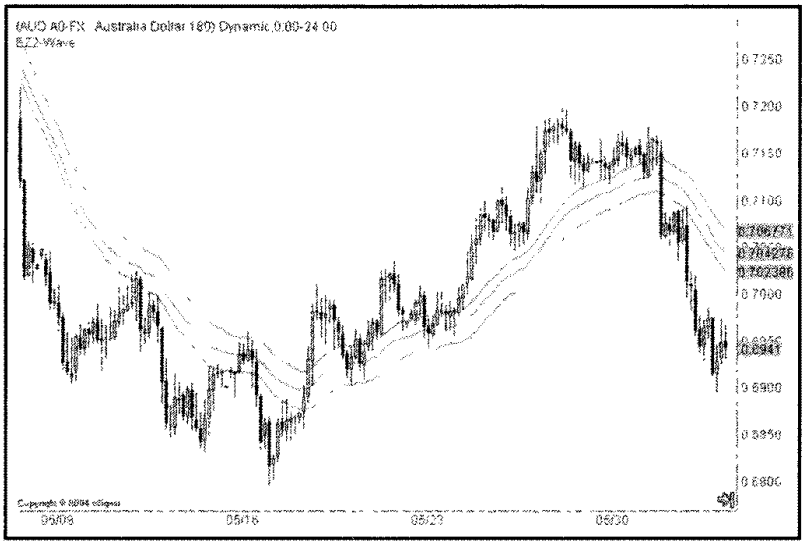

Chart 11.1

Dave and I experimented with the 34 EMA, and I plotted it on the high, low, and close, as I often will if I am looking at a new MA setting for the first time. The first thing I noticed was that when prices cross the three lines of the high, low, and close, it tended to keep going, and pullbacks or bounces in a trend seemed to come right to one of the three lines. It got my interest, and after keeping the 34 EMA on the high, low, and close on my charts for about six months, they earned a permanent place in my analysis. I did test the entire Fibonacci series all the way up to 144, and 34 tested the best. Thus, the "Dave Wave" was born... we call it the Wave for short (Ch 11.1).

Now it's not a magic bullet—nothing is. Here's how to best use the Wave. First, since there are multiple time frames I could be watching and analyzing, I have to be able to decide which has the best trending characteristics. I will go through the 30-, 60-, 180-, and 240-minute daily charts with the Wave on each chart. This visual tool allows me to quickly see if the market has been trading smoothly above or below the Wave, if the pullbacks or bounces retrace into the Wave, or if the Wave is moving sideways and there is no prevailing trend (Ch 11.2).

You'll notice that some time frames don't adhere to the Wave as well as others in certain market environments. This will vary as market environments change from trending to choppy and back again.

Chart 11.2

At least once a day I look at each chart with the Wave.

Another helpful trick when using the Wave is what I call "Chris Clock Angles." I was over at my neighbor's house. We were talking about the markets, and I was showing him some of the tools that I had been using, namely, the Wave. I explained to him that I like to see the Wave traveling in "nice rolling hills" where it isn't sloping or climbing too steeply. My neighbor was still a bit fuzzy about my explanation, so I told him he should just a get a feel for the slope of the trend like a nice 45-degree angle for an uptrend, as too steep or shallow a trend is not what we want to see. His son, Chris, was sitting at the table with us, seemingly uninterested in our conversation until he chimed in, "Raghee, isn't that one o'clock?" I looked at Chris—all of 9 or 10 years old at the time—and said "huh?"

"You know, like, one o'clock." He pointed at my laptop screen and showed me what he meant and then added, "and that's five o'clock." It sunk in. The Wave was traveling between noon and two in an uptrend and between four and six o'clock in a downtrend. When the market was stuck in a range it traveled at three o'clock. And I then realized that sometimes it takes a kid to point out the obvious.

Chris Clock Angles allow me to take a visual measurement of whether the market is in a chop or trending. If the market is in a chop I will look for setups like triangle breakouts and rectangles to set up a momentum trade. If the market is trending at Chris Clock Angles, then I will typically look for bounces or pullbacks to set up a swing trade.

The Wave is by far my most important visual tool regarding trading style. As we discuss swing versus momentum trading, you will see that the clock angle of the Wave will have a huge impact on which style we will trade and, more important, whether we will take the trade at all.

CHAPTER 12

Measuring Trends with CCI on Short- and Long-Term Charts

Measuring Trends with CCI on Short- and Long-Term Charts

Even though I prefer not to use indicators alone when deciding upon entries and exits, they can be helpful to *confirm* trends and reversals. Since we have already discussed the Wave as a visual tool, let's talk about another helpful indicator, the Commodity Channel Index.

It's funny to me now, but when I first started trading commodity futures in college, I didn't know much about the futures market at all. My experience until then was solely based on stocks and mutual funds. I understood price action, drew trendlines, support, resistance, Fibonacci levels, etc., but thought that I needed something more for the futures market. One morning, I was looking through the list of indicators on my charting platform and came across the Commodity Channel Index. It seemed so obvious to me at the time that if I was to be a *commodity* futures trader, I needed to use the *Commodity* Channel Index (CCI). So, using a basic setting of 20, I began measuring the momentum and shifts in trend with the CCI.

Donald Lambert developed the Commodity Channel Index (CCI). The CCI measures the price in relation to a moving average. It is an oscillating indicator, thus it signals when the market is overbought/oversold or when a trend is changing. If the CCI is set to 20, which is a typical or "default" setting, price is then measured in relation to a 20-period moving average.

This chart of the EUR A0-FX is on a five-minute timeframe with the Wave plotted on it. *Remember, the Wave is the 34 EMA on the high, low, and close* (Ch 12.1). I have found that you need volatility to register trendlines and trendline breaks on the CCI itself. From my experience, I would have to say that shorter, intraday time frames are more suited to this, but any chart with wider ranges and volatility will do as shown by this daily chart of the JPY A0-FX.

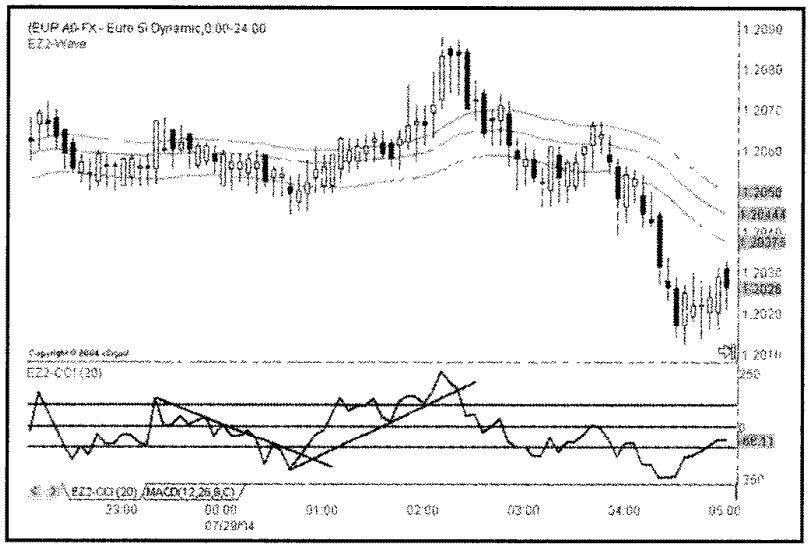

Chart 12.1

The upper and lower bands on this CCI are set to +100/–100. Now some people like to trade off shorter time frames like the five-minute chart I used as an example earlier. I don't. I'd much rather stick with the "slower" times frames of the 30, 60, 180, 240, and daily when I trade Forex. Since we are trading a 24-hour market there is less of a need to use shorter time frames. Traders involved in the futures or stock markets will often use shorter time frames because they are looking for setups in a market that closes each day and may only trade a few hours like the Cocoa market or 7½ hours like the equities market.

And here's something to consider: How *you* like to trade and *your* personality. The truth is there is not just one correct way to trade or one correct time frame! I highly recommend that anyone who wants to be a trader read the *Market Wizards* books by Jack Schwager. Each and every trader in that book is the "real deal." These people walk the talk. What's also interesting to note is that they all don't trade in a similar way... at all! They all have very unique styles, tools, and beliefs. Some are chartists and technicians, some rely on computer models, others are pit traders, and a few use fundamentals. Regardless, they all take money out of the markets on a regular basis.

You need to find what styles, tools, and beliefs you want to adopt and model those traders who have found success with those very same things. Over the years it has become obvious to me that my style is much more breakout/ breakdown oriented. It's just the way I am wired. I like to "stalk" my trades and when the time is right, pounce. Using trendlines, support, resistance, Fibonacci, the Wave, allows me to develop my entire trading plan from entry to stop-loss to profit targets before I enter the trade. But its breakout/ breakdown trading that gives me the feeling of getting in at the

beginning of the move as opposed to trading when the trend has already been established. That is not to say I do not like swing or position trading. I am equally comfortable entering an established trend after a pullback or using a consolidation within the context of the trend. I just naturally gravitate to the style that I enjoy and don't think that won't affect the way you look at the charts. Make sure you know your tendencies.

Another aspect to finding your style—as it pertains to your personality—is the time frame you monitor. I personally find that I am not wired to be a scalper. I like an intermediate to long-term time frame. I like momentum and rather not sit through or wait for swings to enter a trade. We'll talk about scalping, momentum, swing, and position trading later in this book. My point is that you should dedicate some time early on to finding the aspects of one particular style that suit three factors: (1) the time you can dedicate to trading, (2) your temperament, (3) your account size or risk capital.

I have found more than anything that the time you have available to dedicate to trading will have the biggest impact on the style you will succeed with.

Back to the CCI: Contrary to my preferences, it can certainly be a stand-alone to trigger trades on CCI trendline breaks as shown in Charts 12.1 and 12.2. For those of you who feel this might be something you'd like to try, there are a few nuances to watch. Like many other oscillating indicators, there are basically two ways of using the CCI: looking for divergences or as an overbought/oversold indicator. For our purposes, we will use the CCI in its overbought/oversold capacity. Focus on more volatile markets for good trendlines.

There is another chart set up that you may want to consider. It uses the Wave as the entry trigger and the CCI as the confirmation. When looking at less

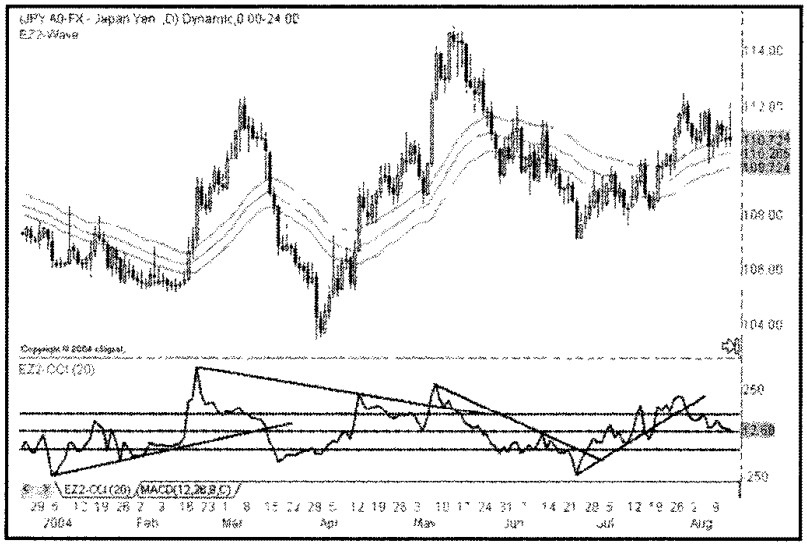

Chart 12.2

volatile or trending markets, you will often see that drawing trendlines on the CCI and then playing the trendline break is not as ideal for the indicator because if volatility isn't there to register good trendlines, it goes against the nature of an oscillating indicator. If you remember Chris Clock Angles you already know how to identify a "good" trendline. Chris Clock Angles apply to trendlines you can draw on the chart or on the CCI. A good uptrend will be between noon and two o'clock and a good downtrend will be between four and six o'clock.

In the Wave/CCI combo set up we would be waiting for prices to make a "clean breakthrough," a Wave that is traveling at Chris Clock Angles. A clean break is when prices trade up through the Wave for the first time. In other words, if prices are already trading below the Wave, then a clean break would be when prices first trade up through it. We call this a "Chris Cross."

The CCI buy confirmation of a clean break up through the Wave would be at least a +100 reading. The sell confirmation would then be a clean breakdown through the Wave with a CCI reading of –100.

The two circled areas show the clean breaks or a Chris Cross on this British pound daily chart (Ch 12.3). The arrows on this chart point out where prices retraced back into the Wave and, held as resistance as in the first case and support, with the second. So let's add the CCI confirmation to see how these set ups come together.

Chart 12.3 shows the same clean break circles as the first example chart, but now we look to the CCI for confirmation of the clean break (Ch 12.4). The upper bands represent +100 while the lower band is –100. Those levels are our "line in the sand." If the CCI reading is between

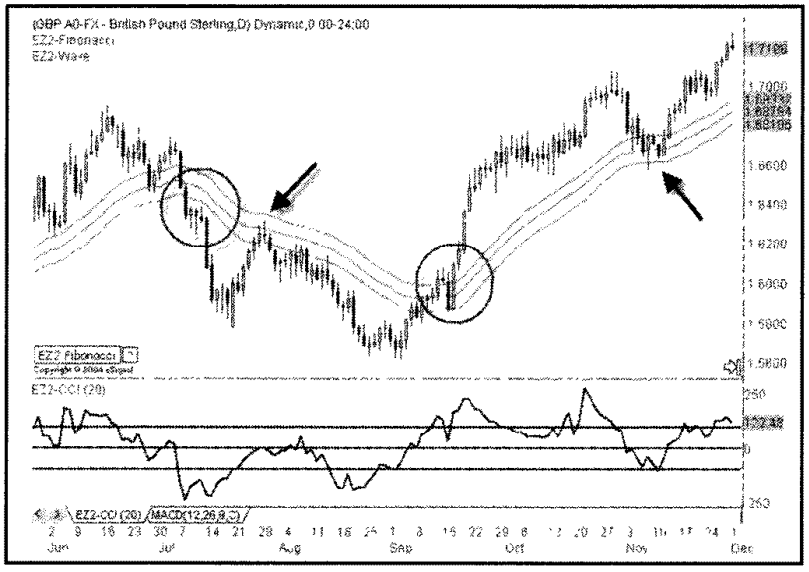

Chart 12.3

+100 and –100 then we have a neutral reading, which we do not act on. For a short trade we need a clean break with a CCI reading of at least –100. For a long trade we need a clean break with a CCI reading of least +100. These are entry rules only. Trade management is done with mainly Fibonacci levels, so let's take a quick look at the chart with all the tools active (Ch 12.5).

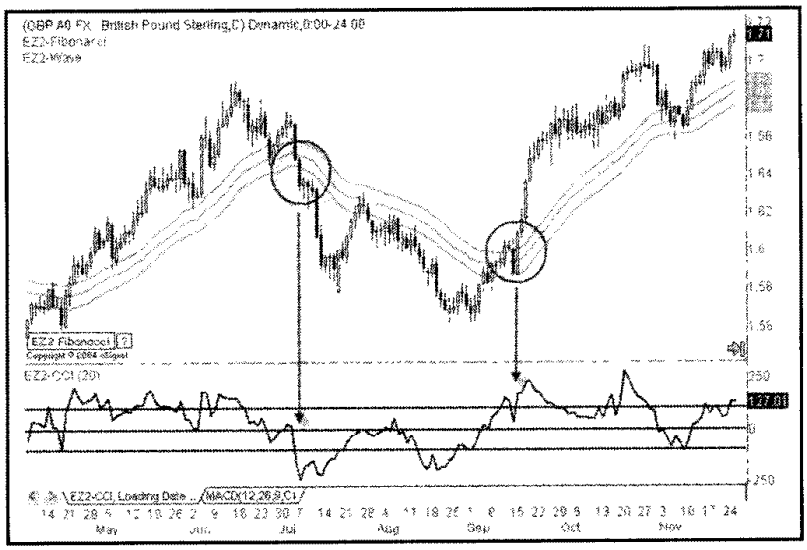

Chart 12.4

Now we can see the uptrend line, and more important, we can see support and resistance levels from the Fibonacci levels. This is especially important as we can see the 1.272 Level will be the next potential resistance level, and the 1.000 should hold as support if prices intend on going higher. The main idea here is to give you an another way of entering a trade; however, keep in mind that we will still use Fibonacci levels, support, resistance, "psychological" or round numbers, to exit at our profit targets. And we'll definitely cover more in depth the above mentioned in Chap. 18, Three Classic Tools to a Three-Step Setup and Chap. 20, Rewriting Trade Management.

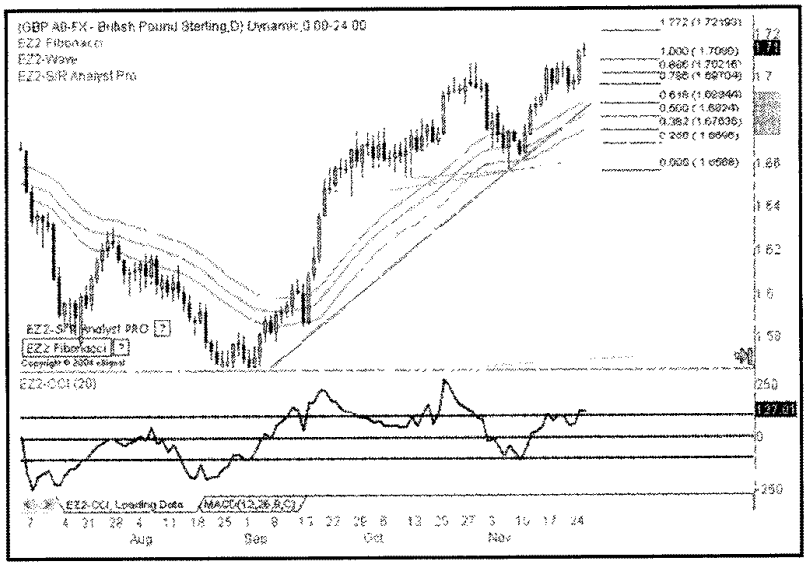

Chart 12.5

CHAPTER 13

Trading Versus Investing

Trading Versus Investing

While it may seem like semantics, it's a matter of goals and methods. Trading and investing are two very distinct ways of engaging the markets.

Most simply put, trading is what's most commonly considered buying low and selling high (and for a short trade selling high and buying back low). Trading is all about looking to profit form a market's ebb and flow, from its rallies and declines.

On the other side of the coin is investing. One of the most commonly used and best examples of investing are mutual funds. Most people with a 401K or IRA have mutual funds. With these you own shares of the fund and typically invest a set dollar amount each month or with each paycheck. There is no timing or consideration of price involved in dollar-cost average-based purchases. Accumulating these shares, increasing one's "ownership" of the fund or a specific stock, is investing. Your goal is to accumulate more and more shares. Of course there is the expectation that the value of the shares will increase; however, the main goal of investing is to accumulate shares or ownership, commonly by dollar-cost averaging, regardless of price.

Most market participants believe they are investors. The connotation of investing is one of value-based purchases, prudence, and safety. On the other hand, most people think of trading as a high-risk activity, more akin to gambling than carefully calculated market timing.

Contrary to popular opinion, a trade can be a two-minute, two-hour or two-year event. The goal of trading is to time an entry and exit in such a way that you can profit from the subsequent price movement. The length of time in the market doesn't differentiate a trade from an investment. It's the goal that separates the two. "Dollar-cost averaging" is something an investor does, and with good reason, as it is the means to their end, which is to accumulate more shares or contracts. Dollar-cost averaging is investing money at a set time (usually monthly) regardless of price

and market condition. When you think about investing, think about ownership. A trader would not (and should not!) even consider this as it is contrary to the timing and price based entries that govern trading.

Another point that separates traders from investors is the stop-loss and heat. What is *heat*? Heat is the amount of points or money a trader will allow a position to go against him or her. Heat is not a consideration to an investor, as dollar-cost averaging does not take into account price or market condition. Where a trader may exit the trade based on price, an investor will be accumulating more shares at a reduced price thereby reducing their cost basis. Cost basis is the average cost of all shares or contracts owned. If an investor bought 10 shares at $20 and 10 more shares at $30, then the cost basis of all 20 shares would be $25.

Stop-losses are what keeps a trader in business: admitting that you were wrong and moving on. There is a set of reasons for traders entering the market, and when those reasons are no longer valid, they should exit the trade. A stop-loss must be adhered to at all times. A stop-loss simply represents the price level at which the trade is no longer valid, where the reasons to be in the trade have been broken. Traders are not interested in ownership. And investors are not concerned with heat or interested in stop-losses to manage the investment.

Why are these important distinctions? One of the most dangerous scenarios in a trade is letting the rules and goals of investing to creep in. Many of us have been there. We hang onto what was to be a short-term trade too long, waiting for it to turn around, and before we know it that short-term trade becomes an investment. We must go into each position knowing what our goals are because each of the two goals comes with their own set of rules and goals.

If your goal is to buy low and sell high, you are a trader and price and timing are your concerns. Trading is an income producing activity. An activity, that if done well, will allow you to invest in various ways. If your end goal is growth of shares or ownership, you're an investor and dollar-cost averaging is typically the method.

I am not here to pass judgment on trading or investing. What I do want you to realize is that each is a powerful way to financial success, in their different ways. Even though I have dedicated this book to the practice of trading, I recommend doing both and diversifying your portfolio and approach to the markets.

CHAPTER 14

The Funnel Mindset

The Funnel Mindset

We are bombarded with information daily. It is our job to sift through what is relevant and what is not in order for us to function day in and day out. Trading is nothing different.

When you factor in newsletters, television, radio, and the Internet, there is no shortage of opinion and commentary that we are exposed to, whether we like it or not. Some of it is tempting and intriguing, but it's our job as traders to stay true to what we know works for us, and to stay true to our plan. Right now, where you sit in your home, office, wherever, you have dozens of noises and sensations around you: *Maybe you have the radio or television on; a fan or air conditioner might be on blowing cool air; the sun is shining or you are sitting near a lamp; maybe dinner is cooking and you smell that aroma; a dog could be barking; a car could be honking.* And we are deleting most, if not all, of that out. We have to! Our mind, consciously and unconsciously, focuses on what we need to. Each day we have to do that same thing when we engage the markets. However, you and I must consciously decide upon what we will allow our mind to focus on.

The Funnel Mindset is what we adopt to consciously to take in all the information we're exposed to and purposely filter it down to the points that will allow us to build our trade. Imagine pouring in all the information in your mind about the market and a particular trade into a funnel; maybe it's one that you're considering now. The overall trend, the patterns, Fibonacci, indicators, and reports, these are all items that will effect our final decision. As all this information is traveling down our mental "funnel" as we narrow the information down and prioritize what will serve our immediate needs to enter or exit a trade. There are three items that we need to decide upon before entering any trade:

1. The entry
2. Potential profit targets
3. Potential stop-loss levels

It's natural to be curious about factors that may seem relevant to our trade, but it's imperative that we filter out everything that doesn't directly lead us to an entry or exit price. *So how do we filter the unnecessary information out?* We ask questions. But what questions do we ask?

The "Ands" and the "Ors"

Entering a trade is a process of asking and answering questions: *Is the trend up or down? Is the market choppy? Are prices trading above or below the Wave? Am I waiting for a pullback or bounce, or am I waiting for a breakout or breakdown? Am I setting up a momentum trade or a swing trade? Where are my swing highs and swing lows? Did my Fibonacci retracement and extension level give me secondary confirmation? Have my trendlines, support, and resistance levels formed a chart pattern? Are there any reports to be released today?* These are just some of the questions I ask myself when I am trading. If you have ever driven a manual transmission car you remember when shifting gears was a very conscious set of step-by-step actions: *Take my foot off the gas, push in the clutch, hold it while I shift, take my foot off the clutch without stalling, get back on the gas.* Soon you did it all without consciously thinking about each step. The "ands" and the "ors" are the same way.

Entering the market is always done with a set of "ands." In other words, more than just one thing has to happen for us to enter a trade, preferably two or three things. For example, an upside trendline break for a momentum set up may require that the trendline breaks *and* is not trading too close to a Fibonacci level that may act as resistance *and* has either a sideways or noon to two o'clock Wave, *and* I am not trading in front of a economic report, *and* my risk/reward ratio is at least 1:1 or better. If any one of these criteria weren't where we needed it to be, we would not take the trade. Think of an airplane taking off and the checklist a pilot goes through. If one item on the checklist isn't okay, the plane won't take off.

Exiting a trade is done with just an "or." And remember exits can be both stop-loss exits and profit targets. For example, if you took the upside breakout we were just discussing and prices are now trading at the first profit target, that alone is enough to exit. In this case you will exit out of one or more of your lots. Let's say that the breakout failed and prices are now trading at your stop-loss . . . again. That too is reason enough to exit! So your mindset for exits will be whether my profit target was hit *or* my stop-loss was hit *or* an economic report

is going to be released so I don't want to be in the market *or* I am nearing a "psychological" or round number...so I want to exit one or more of my lots. A **lot** is like a share of stock or a contract in the commodity futures market; it is simply one unit.

Sadly enough some traders in an overeager attempt to make money will overtrade. You will notice that losing traders will use "ors" to enter markets and "ands" to exit them! Just ask them what needs to happens for them to enter or exit a trade, and you will begin to understand the questions they ask themselves to qualify their actions. If you find yourself doing this, dump a bucket of cold water over your head and snap out of it! (Just don't do it near your computer.)

CHAPTER 15

The Difference Between Scalping, Momentum, Swing, and Position Trading

The Difference Between Scalping, Momentum, Swing, and Position Trading

Let's begin this discussion with the understanding that the definition of scalping, momentum, swing, and position trading will vary from trader to trader.

We need a baseline so I will describe each of these trading types as it pertains to how you may want to incorporate each into your approach to the markets and also which you find you may begin to adopt more actively into your trading day. There is one idea—I should say one myth—that needs to be dispelled. Trading types have nothing to do with how long you are in a trade. The idea that a trade is defined by the time spent in the market is ridiculous. Trade types are defined by how you enter a trade, not by its duration. There are only two reasons to exit a trade: because your stop-loss was reached or because your profit target was reached. The time it takes to do either is irrelevant. With that said, we'll cover scalping first.

Scalping, in my opinion, is an "advanced" type of trading, not because of the style itself, but because the speed at which you must be able to recognize the trade set up and execute the order. Scalping is often the best choice for floor or pit traders since they have a unique vantage point and the quickest execution response to order flow. Scalping is typically done using very short-term intervals, like one-minute or tick charts. This is because scalpers want to be out before the slightest pullback. Scalp trades are done in the direction of the current trend and allow a trader to take small "bites" of the overall move. Scalpers may enter and exit a number of times along the same trend taking small pieces as the trend persists. Scalpers may not be the first ones in the trend, but they are always the first ones out. Quick thinking and quick reflexes prevail, and an error in judgment can often wipe out an entire day's profit.

If I sound a little down on scalping, that's my experience and personality coming through. It's my least favorite style. But let me add that quite a few of my close trading friends and partners are world-class scalpers and there are many people

who enjoy the action and are comfortable with this style of trading. I just happen to not be one of them. If you are a new trader, please humor me and learn to momentum, swing, or position trade first then go seek the tutelage of an experienced and successful scalper when you are ready.

The next style we'll discuss is momentum trading. As I have mentioned before, this is my favorite style but not because I consciously chose it. I think you will discover that many times your style will choose you! Momentum traders wait for breakouts and breakdowns as a clear signal to a shift in momentum, coming out of a trading range or consolidation. Traders that prefer to trade chart patterns like triangles, pennants, and narrow sideways channels are typically momentum traders. Momentum traders stay in the trade for the duration of the trend's momentum and consequently will not sit through significant pullbacks. Which brings us to swing trading.

Swings can be defined as the pullbacks in uptrends and the bounces in downtrends. Swing trading is predicated upon the belief that once a trend is established it will continue until the trend shifts in the other direction and reverses. Swing traders will buy pullbacks in an established uptrend and short bounces in an established downtrend; chart analysis will show us specifically when to do so. Swing trading is the best way to enter established trends since you will not buy into the highs or short into the lows. In fact, if you missed an initial entry in your momentum trade, it is often best to put on your "swing trading hat" and wait for a pullback or bounce if the trend continues.

When you have exited out of your entire position, that is what's called being "flat." A sell-stop is your stop-loss in an uptrend and would exit you from a long position; and a buy-stop is your stop-loss in a downtrend and would exit you from a short position. One idea I encourage all traders to adopt is to look at the market from both directions. When you are looking at a buy, take just a moment to see what someone who is thinking of selling might be seeing. Always, take a moment to step in the shoes of a trader who may be on the other side of your trade. Many people who come from an investing background will typically only look at the markets from the long side or as buyers. Doing this severely limits the opportunities that are available to you in any market. Professional traders sell short as frequently and as comfortably as the buy long. For those of you who may not be completely familiar with shorting, it is simply taking a trade that allows you to profit as a market falls. When we go long, we buy contracts in expectation of rising prices. We will eventually sell

them and realize our profit. Conversely, when we short a market, we sell contacts in expectation of falling prices. We will eventually buy back these contracts and realize our profit if the market is lower than when we initially sold it. What I'd like you to come away with here is that each style has it's own rules. The entry rules are what distinguish one trading style from another.

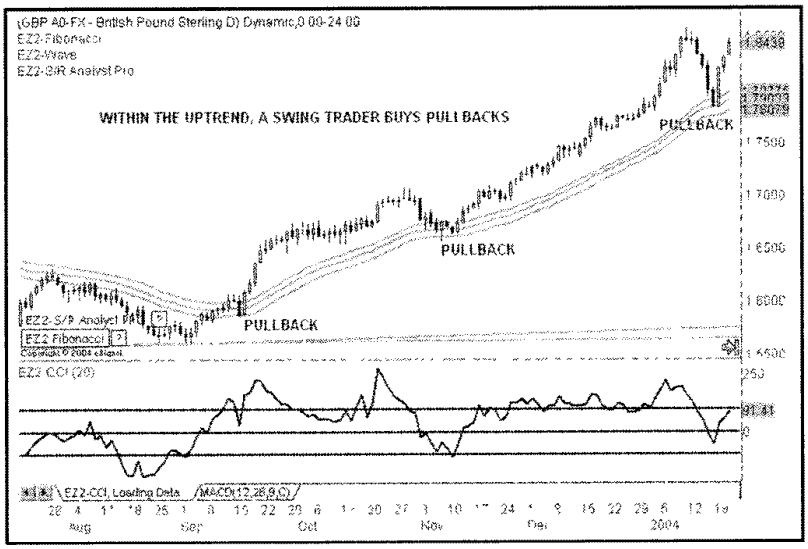

Chart 15.1

Let's take a look at an example of a swing trade, and a momentum trade. Ch 15.1 shows the pullbacks within the uptrend. In this case we are looking a pullbacks to the Wave. You may of course use Fibonacci levels as well; personally I prefer the Wave. Just keep in mind that we are looking for "measured pullbacks or bounces." A measure pullback is simply a price level that we have determined before entering the trade will offer support or resistance within the context of the current trend. Measure pullbacks can also include psychological or "round numbers." Ch 15.2 shows the support of the uptrend line and the resistance of the downtrend line forming a triangle.

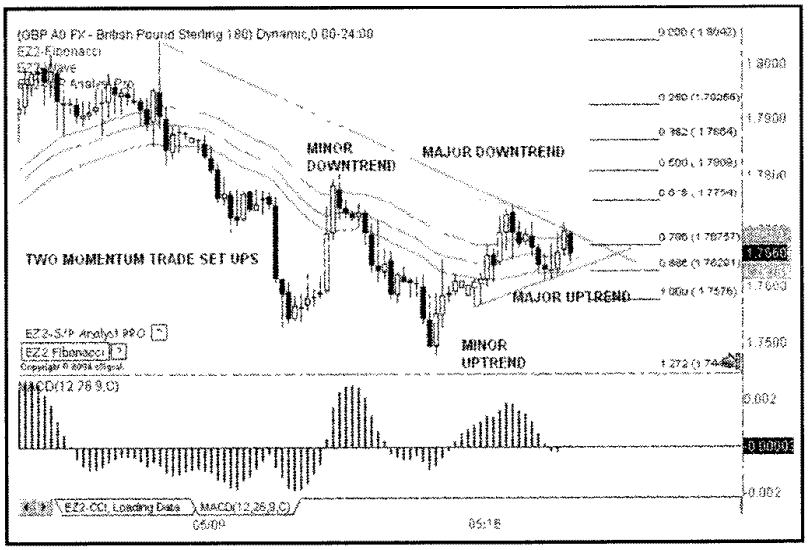

Chart 15.2

CHAPTER 16

Two Cornerstone Steps of Trade Setups

Two Cornerstone Steps of Trade Setups

The cornerstone of my trading can be summarized in two easy steps:
(1) Find the trend: short and long term.
(2) Find potential reversals within the trend.

Let's explore this further because this is the mindset behind each of my trades. Now this may sound remedial—if not outright obvious—but a trade is made up of three points:

1. An entry
2. Potential profit targets
3. Potential stop-loss levels

I use three tools to support these decisions: Fibonacci levels, trendlines (including support and resistance), and my trend indicator, *aka* the Wave. Here's an example of a typical chart. On this daily chart of symbol EUR A0-FX, there are three tools active on this chart (Ch 16.1).

First, let's look at the Wave plotted by the triple lines. Next we can look at the two trendlines on this chart, and finally the Fibonacci levels on the right side.

So how do these tools help me reach a decision on my three points?

Since we've already talked about how a trade begins with the process of asking and answering questions, the first question I ask myself is whether I am on the "weak" or "strong" side of the trend. Looking to see whether the market is trading above or below the Wave easily accomplishes this. On this chart (Ch 16.1) you can see that we are on the weak side of the trend. Weak means that a short would be with the trend, while a long would be against the trend. We will cover this in great detail when we discuss Prep Work, Chap. 17.

The second question involves finding potential reversals within the trend. In order to pinpoint profit targets and stop-loss levels I must decide upon where I think the trend is most likely to reverse. A reversal in the direction of my trade will set up my profit targets while reversals in the opposite direction of my trade are the areas I will look to place stop-loss orders above or below. For example, if I were in a long trade, my stop-loss would be placed just below a support level, while my profit targets will be placed approximately five pips below the resistance levels. I use Fibonacci levels to accomplish this. These levels allow me to find support and resis-

tance levels within the context of the trend, or the "last major move."

Chart 16.1

The next chart of the 60-minute euro shows how this works. (Ch 16.2) The last major move in this case was from 1.2389 to 1.2173. The price level of 1.2173 represents a 1.000 or full retracement, while the 1.2389 level represents the end of the "last major move," which in this case was a rally. The price action that comes after the 0.000 level is now considered a retracement.

Therefore, the Fibonacci levels on the right side of Chart 16.2 show where this market is most likely to trade to and then potentially find support and resistance. *(When working with support and resistance, like Fibonacci levels, what was once support becomes resistance when prices trade below it and what was once resistance becomes support when prices trade above it.)* With the gradual drop from the high (the 0.000 level), we can see that the market found short-term support at the 0.250 then the 0.382 Fibonacci levels and then sliced through the 0.382. The 0.500 level finally brought some support. In a hypothetical trade, each level could have been a potential entry or profit target for a short. (Remember, I am only

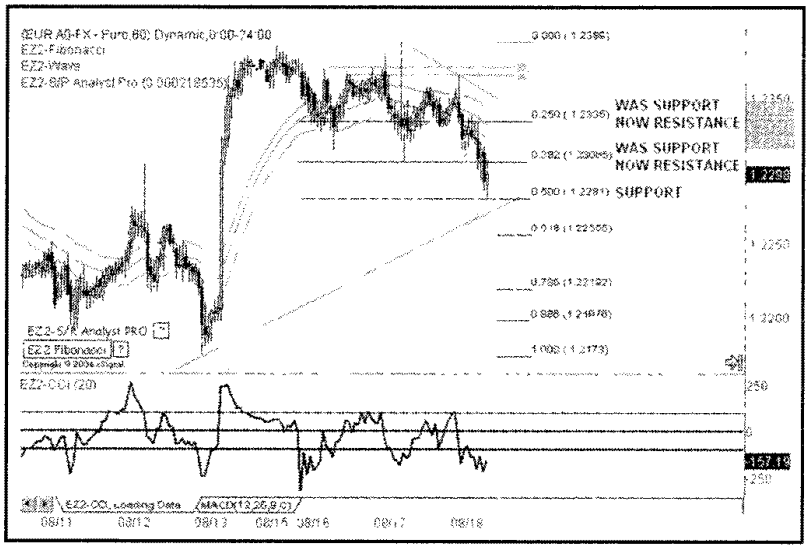

Chart 16.2

considering trade management here. These are not entry rules.)

Since we know the rules that govern past support and resistance level, these levels have not outlived their usefulness yet! Now each one of these potential support levels are all potential *resistance*. But Fibonacci Levels are not the only support and resistance we should watch for. Currently we see that the downtrend line is holding prices from trading higher (Ch 16.3).

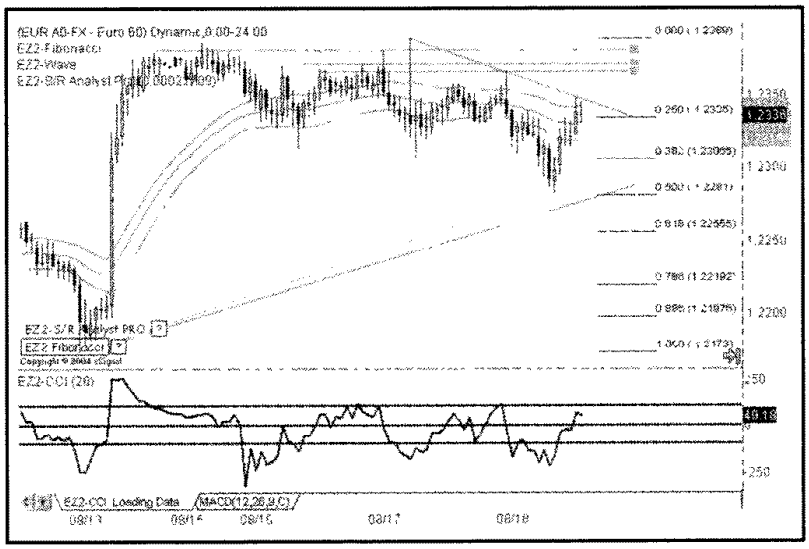

Chart 16.3

Think of horizontal support and resistance levels like a multistory building. Each floor is a support and each ceiling is resistance. However, what may be one person's ceiling is the floor for someone above. That's how support and resistance works, so it is important to watch them going up and down. I can also use these levels as stop-losses. For example, a short entry could have one of the profit targets at the 0.250 Fibonacci level. *(I like to place my orders at least five pips above in a short.)* since prices bounced there, so now the 1.000 Fibonacci level could be a ceiling or resistance, and also a stop-loss if I had more of the position left and wanted to protect my profits.

Let's discuss some distinctions about entries. **Entries depend upon whether we are momentum trading or swing trading.** For momentum trades we will use trendline, support, or resistance breakouts or breakdowns. For swing trades we will rely on pullbacks or bounces, otherwise known as retracements. These retracements will most often be to Fibonacci levels or the Wave and occasionally to trendlines, support, or resistance lines. Regardless of your entry type, I have found that mos trades are made or broken by the exits. Entries are the easy part. Now this does not mean that we are allowed to enter late or with sloppy execution and chase trades. It's just that I have seen, time after time, that well-timed exits are what oftentimes makes the difference between pocketing a profit and breaking even. Exits come in two

types: profit targets and stop-losses.

Exits must be supported by price action. If a trader enters a market based on the chart, then any exit—profit or loss—should also be based on the chart. This is why I am always searching the charts following my two steps: *(1) Find the trend: short and long term. (2) Find potential reversals within the trend.*

Chart 16.4

With this philosophy in mind, let's take a look at a current view with all the analysis so that you can make some decisions of your own. Check out the chart of the EUR A0-FX on the 60-minute time frame with the Fibonacci levels, trendlines, and the Wave (Ch 16.4).

As you look at this chart I want you to think about a few things:

The Wave is neutral (moving at three o'clock). See how it's more sideways and that prices are trading within it rather than above or below? Are we setting up a potential momentum or swing trade? If prices break out, what level is your stop-loss at and where will your first profit target be? What if prices break down?

Here's how I would analyze it (Ch 16.5).

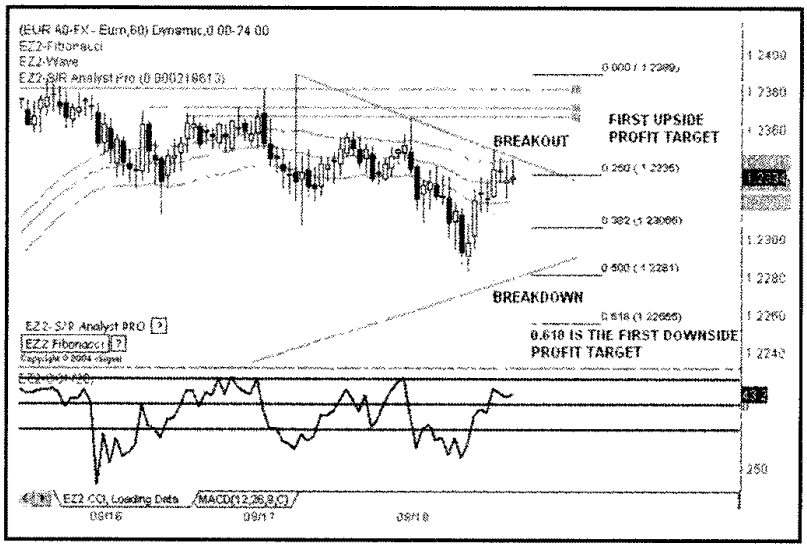

Chart 16.5

CHAPTER 17

"Prep Work"

"Prep Work"

Before beginning the "three classic steps" of building a trade, there is one step that we all must do, and that's make sure we're looking at the best time frame.

Even though this is relatively easy "prep work," it makes a huge difference in the quality of the trades. Consider this the foundation of all trades.

Finding the overall trend on each time frame, even if making a mental note, is key. I like to write this info on an index card. In fact, I write down all relevant numbers for any trade set up on a 3 x 5 index card. This means that I write the five time frames that I scan on each index card. These are the 30, 60, 180, 240, and daily. (*There are other time frames that you can look at as well. These are typically very short time frames like the 5-, 10-, or 15-minute charts. I prefer not to trade on time frames that short, but the tools work on all time frames.*) Next to each time frame I will draw a small arrow to show the prevailing trend, whether that be an uptrend, downtrend, or a sideways market which would show no trend: **# $ 1**.

This first step can be accomplished quickly and accurately with the Wave. Remember the Wave is a 34 EMA on a high, close, and low. With the Wave plotted on each of the time frame, we want to take a quick visual account of the quality of the trend. When I say "quality" I mean: At what "clock angle" is the trend climbing or falling? Has the market made a retracement? No trend goes straight up or down, they all retrace at some point. Retracements are those pullbacks in an uptrend or bounces in a downtrend. Look for trends trend that climb with the Wave and retrace back into the lines of the Wave. The retracement may not be perfect, but as you do this over and over again on different pairs and time frames you will be able to tell good Wave retracements from bad ones. Be conscious of the fact that you are now training your eyes to notice certain things. Notice the way a trend climbs after an initial breakout or how it looks as it weakens. When the trend does retrace, does it pull back before the Wave

or does it trade through the Wave like it wasn't even there?

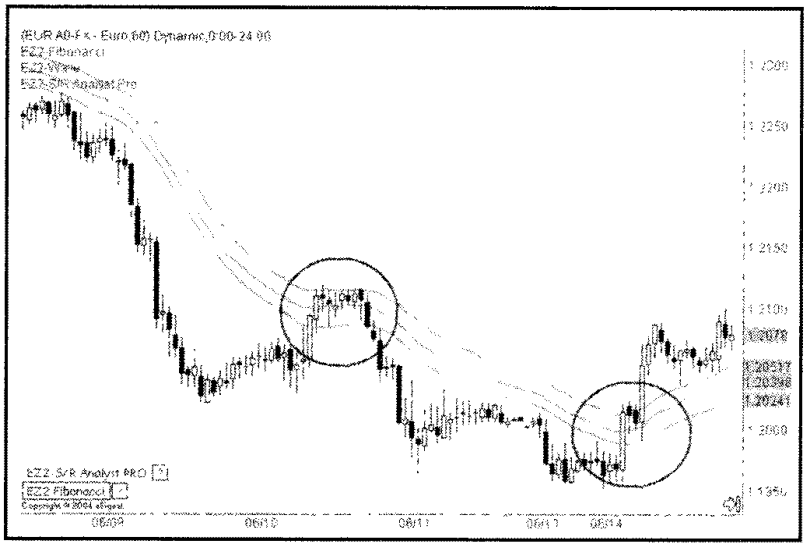

Chart 17.1

Let's look at some examples. This first example is of the euro on a 60-minute interval (Ch 17.1). We use the *look back* numbers to get a proper read on the current trading environment. (If you need to refer to the appropriate look back for each time frame, revisit How to Draw Trendlines.) The five trading days in this example show where prices have retraced into the Wave in the downtrend. The last test on June 14 shows a clean crossing of price through the Wave and thus the downtrend was broken as measured by the Wave. Notice that the retracement we see during these five days went right into and not beyond the top line of the Wave. These retracements are exactly what we want to short in an established downtrend when we are swing trading.

The next example is the British Pound on the daily chart (Ch 17.2). In this case we have gone back to the first week of July '03. When looking at the Wave on a daily chart, I will typically go to the most recent trend change or "Chris Cross" through the Wave. This allows me to see any retracements as well as how and where the trend began which will allow me to make a decision as to whether I will be setting up a momentum or swing trade.

In this case there was a "Chris Cross" in mid-September '03. The uptrend that followed retraced into the Wave three times during the uptrend. This example shows that the uptrend followed the Wave and that the retracements did not break the bottom line of the Wave. These retracements are exactly what we want to buy in an established uptrend when we are swing trading.

Now let's a take a look at a market that is not following the Wave, thus making it a time frame that currently would

not qualify as a trending market. Of course, this does not mean we will not consider a set on this chart, it simply narrows down the choice to momentum trading. In this case we can revisit this chart and mark our trendlines, support, and resistance line to take note of any triangles, pennants, or rectangles that might be forming.

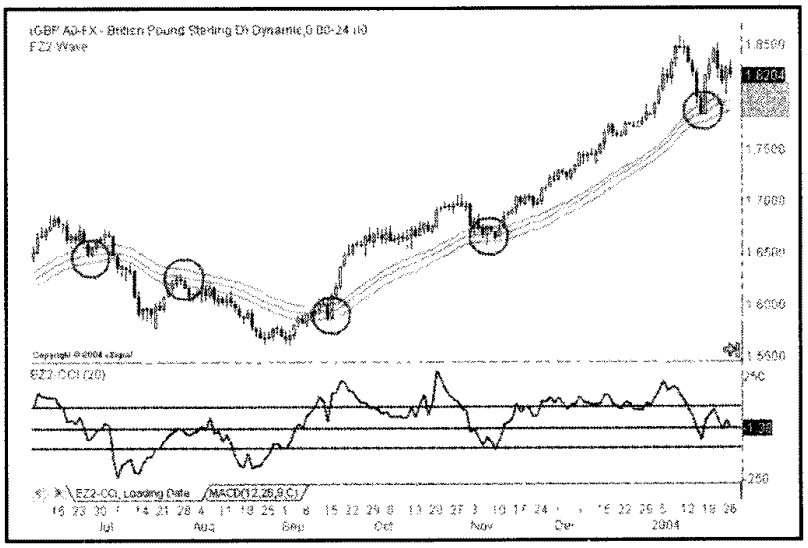

Chart 17.2

The arrows on the next chart example the British pound on a daily chart show many Wave breaks (Chart 17.3). This tells us two things: first, the trend is not a smooth one, and second, there is too much chop to safely enter a swing trade. This brings up a powerful point.

When the Wave is haphazardly broken into the upside and downside without a subsequent trend, the market is most likely trading a range or "chop," which means we will watch the chart for a possible momentum trade.

This next chart of the euro on a daily time frame shows what happens when the Wave is moving sideways (Ch 7.4). We can see that prices are stuck in a range and certainly not ideal for swing

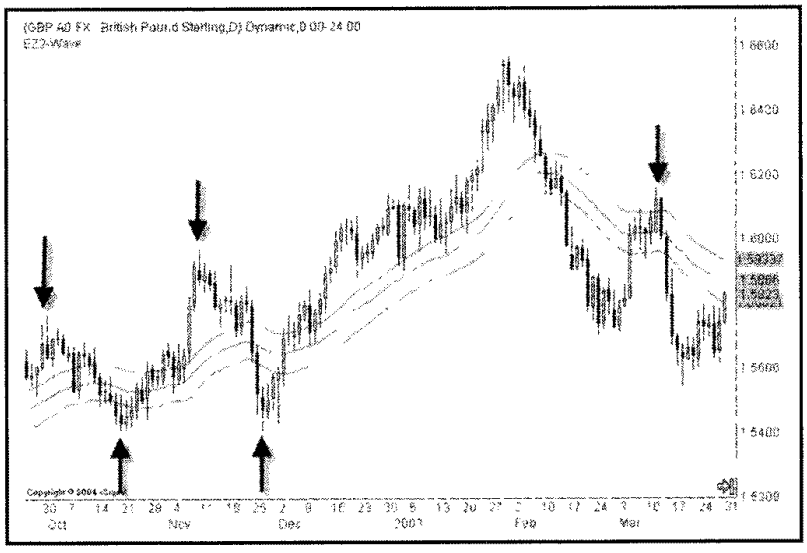

Chart 17.3

trading. Remember Chris Clock Angles? The chart shows an angle of three o'clock. If the Wave is not traveling at between noon and two o'clock for an uptrend, or between four o'clock and six o'clock for a downtrend, we should stay away from swing trading. And here's another important point: Just because the Wave is not ideal for one type of trade doesn't mean that we should give up on that market altogether, we will simply move on to the next of our five time frames. We are can scan through the 30- 60-, 180-, 240-minute, and daily charts.

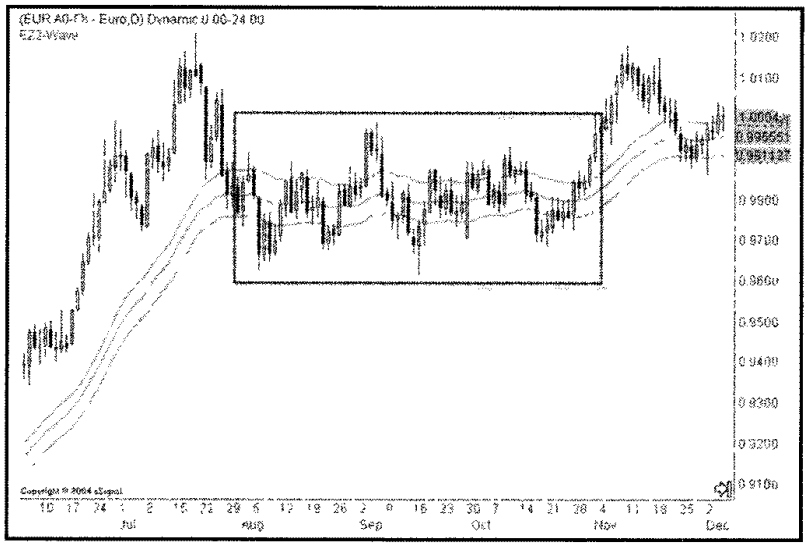

Chart 17.4

Markets follow a four-phase cycle (Ch 17.5). As traders we look to differentiate the up and downtrends, which are ideal for swing trading, from the sideways trend. First, the Wave and, second, drawing trendlines, support, and resistance help us to this very effectively. When a market begins to lose momentum at the end of an uptrend (also called *markup*) it will many times transition into a choppy phase we call *distribution*. The distribution is typically volatile. At the end of a downtrend (also called *markdown*) the

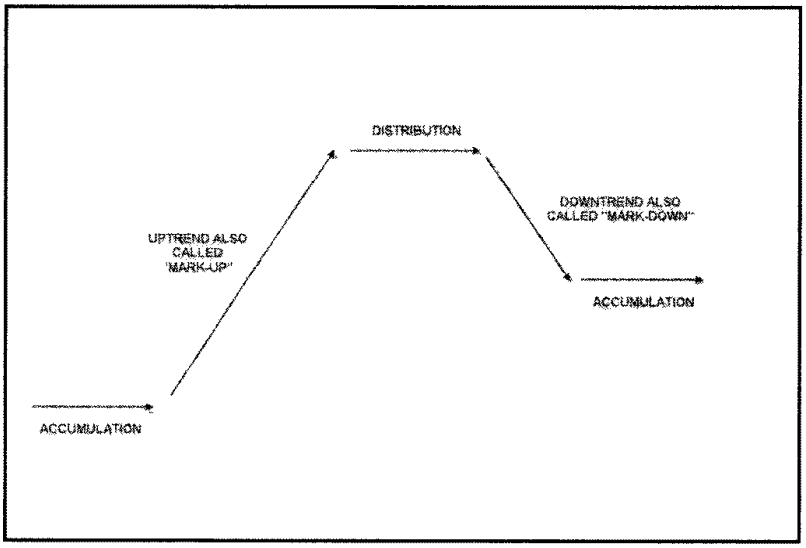

Chart 17.5

market will also tend to enter a choppy phase called *accumulation*, which is markedly less volatile than distribution. Both these phases are more suited to momentum trading.

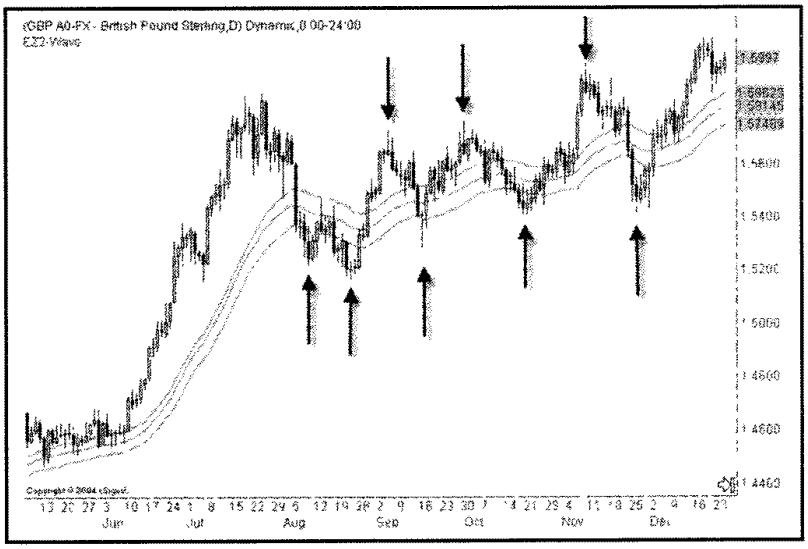

Chart 17.6

Last, we'll look at a good example of transition on the daily chart of the British pound (Ch 17.6). The chart shows a steep trend going into mid-July. By early to mid-August we see that the Wave was broken to the downside thus ending the uptrend. The price action that follows shows how powerful an analytical tool the Wave can be. Notice how it is no longer trending between 12 o'clock and 2 o'clock?

So by now I hope you understand how I conduct my "prep work." It will take some time to train your eyes to find the "best" market environment, and believe me, its well worth the time and effort. With some practice, it will soon become automatic. Once we find a time frame that climbs smoothly with the Wave and retraces back into the Wave, then we have a potential swing trade set up. If we have a time frame that shows a choppy market that does not obey the Wave or show a Wave traveling at three o'clock, we have a potential momentum trading set up. Once we know which set up we are most likely working with, we can begin to draw trendlines, measure recent major rallies or declines with Fibonacci levels, and to confirm and build our trade.

CHAPTER 18

Three Classic Tools to a Three-Step Setup

Three Classic Tools to a Three-Step Setup

If a trader spends a few weekends reading some of the trading books from the early 1900s (specifically books by Richard D. Wyckoff and Richard W. Schabacker), it is eye-opening to see that even though we have the technology of today—computers, the Internet, instant quotes and charts—the nature of the market has changed very little, if at all.

And that's because the motives and emotions that rule the market have not changed. Fear and greed rule...and probably always will. Because of this fact, I purposely sought out books written in the early 1900s because the "crutch" of television and computers were not available to these traders. In my opinion, these books focus on price and chart patterns more than books written in the latter part of the century. Price and chart patterns are the most direct way to measure market emotion.

Analyzing price and chart action using the "classic" tools is a tried and true formula. That's not to say indicators are not powerful assets—you know that I use a set of Moving Averages, aka the "Wave," as well as the Commodity Channel Index (CCI) to add depth to my analysis. Let's focus on the three tools that start my analysis of any market: Trendlines, support and resistance lines, minor highs and lows, and Fibonacci levels.

While what we are about to discuss will show how a three-step setup works in the Forex market, it can and does work on everything from stocks to E-Minis, intraday, and end-of-day. Remember that your trading style will dictate how you will use each of these tools for your entry strategy. Many times after you analyze the chart, you will see that one style is better suited than another in the current market environment. For example, because the market is already trading in an

established trend, you may focus on swing trading. Perhaps you missed a momentum trade; in that case the three-step analysis will help you set up a swing trade.

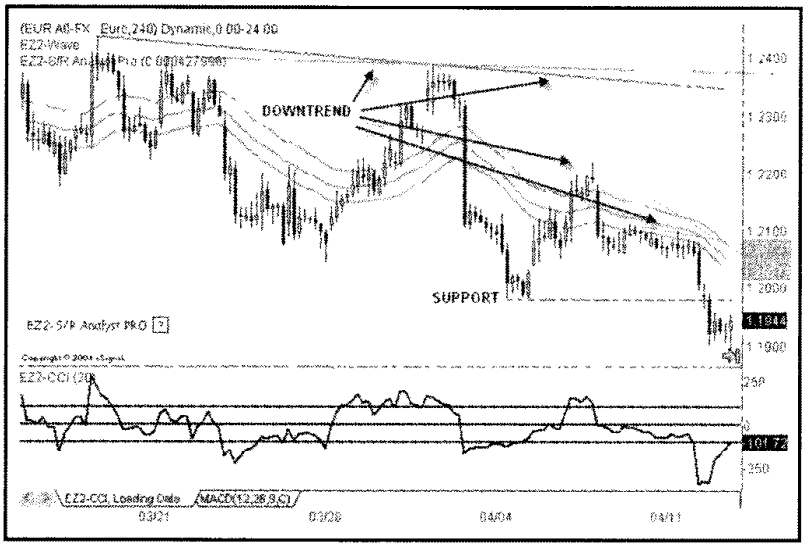

Chart 18.1

Let's begin. First, if you haven't done your prep work please go back and do it! If you have already, great! Step one is drawing major and minor trendlines. Many first-time traders enter positions without respecting the support and resistance of major and minor trendlines. Knowing where the trend is heading is a simple but key point that can begin with the Wave, but eventually you and I must draw trendlines, support, and resistance lines to pinpoint the price levels that we will watch.

The trendlines in Ch 18.1 show multiple downtrends. While the major downtrend line is a thicker line, it is important to note the minor downtrends marked by the thin lines. We can also see a horizontal support level. Trendlines, support, and resistance are all related and are all the building blocks of chart patterns. If you find these levels, you will also find any relevant charting patterns because most, if not all, chart patterns are made up of some combinations of trendlines, support, and resistance levels. The next step is to locate the "swings" by finding the minor high and low patterns on the chart (Ch 18.2).

Minor highs and minors lows are helpful because they are an easy way of identifying the swings in the market. (See Chap. 10, Fibonacci Levels.) Our goal is to find an accurate way to methodically locate the most recent and relevant swing high and swing low from which we can draw Fibonacci levels. Drawing the Fibonacci levels is step three.

Since we know how to locate the minor highs and minor lows on the chart, we can accurately draw the most relevant Fibonacci retracements and exten-

sions (Ch 18.3). The result is a set of levels that will offer support and resistance until the next major rally or decline. The analysis shows us that the 0.618 and .786 Fibonacci level acted as resistance. The 1.000 level was briefly support before prices fell through the 1.272 and 1.618 levels. While the 1.886 level wasn't hit, prices did stop just above it. The most recent few candles show that the 1.618 level is currently resistance.

Chart 18.2

Each one of these steps unveils an important piece of the analysis puzzle. Trendlines without Fibonacci levels would only show the trend yet would not reveal all relevant support and resistance levels. Fibonacci levels without trendlines would not show potential trendline breaks and the current strength or weakness of the market. Putting these two tools together yields the two most important facets of any trade: where to enter and where to exit. Everything outside of those two facts is extraneous regardless of whether you are momentum or swing trading. For example, if you were to be swayed

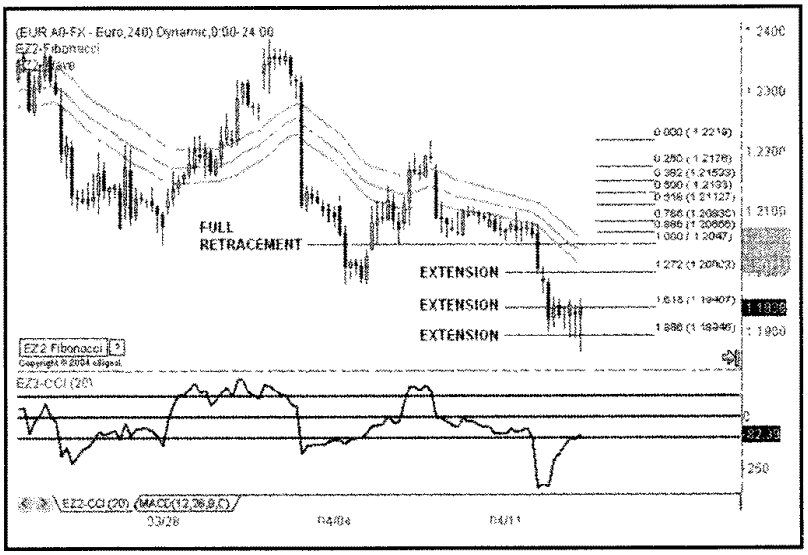

Chart 18.3

by a particular piece of news that changed your bias, that in itself is not wrong but ask yourself these questions: Does the news tell me at what price to enter or exit? You will find that it seldom does because there is no way of calculating what the reaction will be. Instead, consider these questions: Did the release of this news effect price action in a way that prices reached my profit objective or stop-loss? Did it trigger my entry price? Did the news affect the current trend?

If traders want to know if a trend is weakening, they need only to see if the Wave is flattening out. Of course, the most obvious sign would be a trendline break. If traders want to know where to take profits or even where to potentially place a stop-loss, they can use Fibonacci levels and "psychological" or rounds numbers. Psychological numbers are simply whole or round numbers. Limit orders, especially, tend to be placed at numbers ending in 0, for example, 1.2200 or 115.50. Orders congregate at these levels, creating support and resistance. It is for this reason that when one of my entry or exit prices is close to a psychological level, I will check to see whether my order will be sitting above or below it. The reason is because the support or resistance created by the psychological level could effect my order execution.

If we zoom out to the 60- minute chart, we can see the same downtrend lines that were plotted on the 240-minute chart; however, we can also see a new resistance level just above 1.1950 (Chart 18.4). What is important to note is that as you move from longer time frames to shorter ones, you will often see short-term levels that can set up breakouts and breakdowns.

If we zoom out to the daily chart, we can see a congestion pattern forming, in this case a pennant, which is a triangular

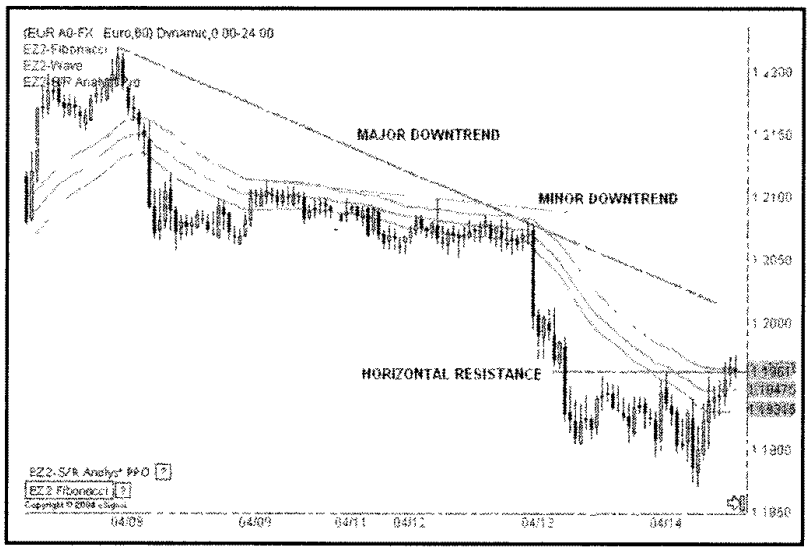

Chart 18.4

pattern that consists of a downtrend and uptrend line that are either about to or actually intersecting (Ch 18.5).

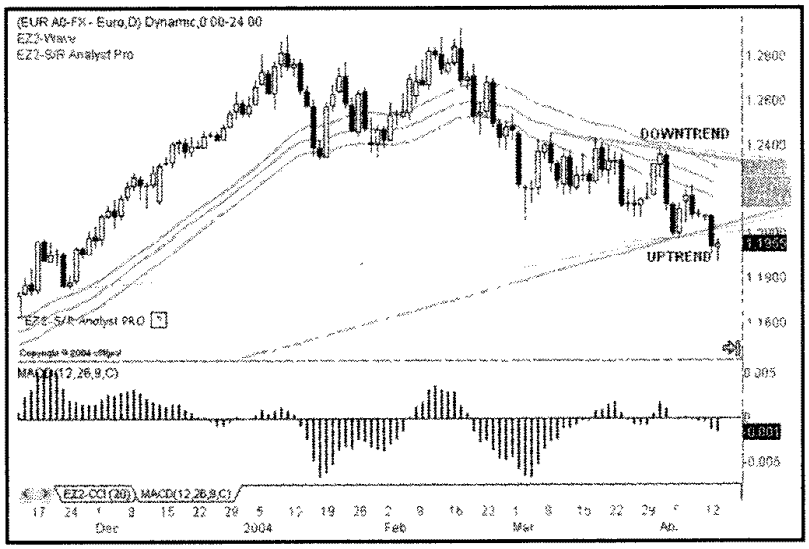

Chart 18.5

The power of watching multiple time frames, in this case the 60, 240, and daily charts, can open up the possibilities of many trading setups thus giving us the choice of picking the setup that suits our risk tolerances and trading style best. Just remember that eve though each chart is analyzed with the same tools and same methodology, each is treated individually as a trade in its own right. The key to trading success is analysis using tried and true tools and a consistent approach, and now we know how we can choose which setup will suit us best. Again, there is no such thing as the "right" trade. The best thing we can do is choose which trading style is appropriate for the current market environment (i.e., swing versus momentum). Now that we have a broad overview of the three classic steps, let's get an in-depth look at each one.

CHAPTER 19

Building a Trade

Building a Trade

I have a philosophy when it comes to consistency in my trade: recognize, react, repeat. Those are my three Rs. That's the backbone of building a trade.

We want to use the same steps so that we can analyze the market without emotion and without getting too caught up in the moment. The key is consistency. We want a consistent plan to enter a trade and set profit targets and stop-loss levels. Having a methodology is important to success because without a plan to follow, we will be open to outside influences, which is something that I sadly see too often when I see other traders... new and experienced!

Building a trade means just that: We will follow a blueprint in the expectation that we can and will produce a repeatable result. Our final product is a successful trade. Though "success" is not just simply defined as a profitable trade, as many traders would think. A successful trade is one that is built, using price and chart action, with a specific entry, profit targets, and stop-loss. Even if the trade gets stopped out, believe me that is still success! It means that you were following the plan. The worst, most dangerous trade anyone can make is one that breaks the rules—like chasing a trade or not adhering to the stop-loss—and still makes a profit! This alone has been the demise of many a trader in the long run because there is always the temptation that if we got away with it once, we can get away with it again. You've chosen to read this book to learn a skill, perhaps even build a new or second career. Learning these next three steps is the first step in the right direction.

Throughout the years, I have traded many markets, intraday and end-of-day: Stocks, futures, and Forex. The blueprint I am teaching you will work on any market and any time frame because it's not some new trick or secret indicator. It is the culmination of three time-tested classic tools that rely on price action and the natural ebb and flow of the market to

dictate where and when to enter and exit the market.

Step One of Building a Trade: Draw Your Trendlines

The first step is to locate the trendlines on the chart. I recommend you look at a lot of charts so that you may begin to train your eyes to notice the lines (trendlines) and levels (horizontal support and resistance) that make up a trend and any chart patterns. Practice makes perfect. Since we have completed the prep work that precedes any trade setup, we have a good idea of the direction and strength of the trend based upon what the Wave has indicated. Drawing lines and levels allows us to see the specific prices that we will watch to enter and manage our trade. (See Chap. 8, How to Draw Trendlines.) Don't forget that we are looking for both major and minor trendlines.

In this chart of the euro on a daily time frame we see that there are two downtrend lines, one major and one minor (Ch 19.1). Notice the support level, which as we know represents buyers. This chart shows us two things. First, the market is in a downtrend. Second, and more important, there is a strong support level that is the floor of a consolidation pattern. Consolidation means that we are seeing the trend flatten out and a range form. Since the beginning of May you can see that prices are more choppy than in a downtrend. You can call it a trading range or a rectangle pattern but the bottom line is that it is best to wait for a breakout/breakdown and set up a momentum trade.

The next chart of the British pound shows a total of three trendlines (Ch 19.2). The trendlines are forming a triangle or pennant, which is a consolidation pattern.

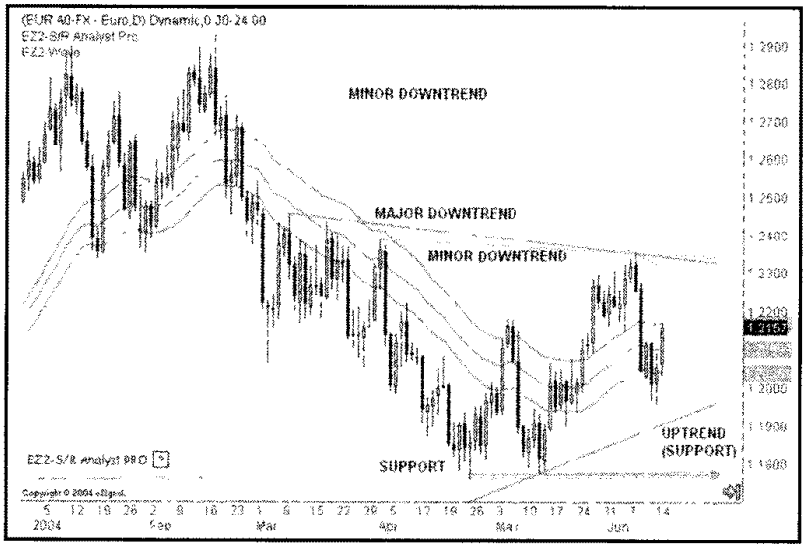

Chart 19.1

The first thought that should run through your mind is that there is no dominant trend. The second thought is that entering the market before a trend reveals itself (by a breakout/breakdown) would be a low percentage trade. However, this is a great chart to keep an eye on since we can wait for this momentum trade to set up and confirm.

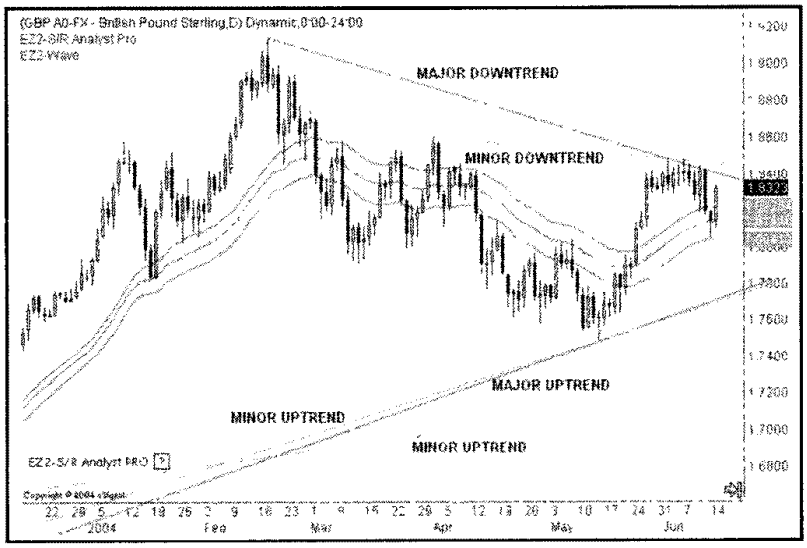

Chart 19.2

While trendlines alone seem to be giving us a lot of insight into any trade setups we may want to take, we can do even more to set up and confirm a trade, namely, draw Fibonacci retracement and extension levels. But first we have to determine from where we will draw them, and you now know that means we look for the swings in the market. Since we have drawn our trendlines, support, and resistance already, some of those peaks and valleys we connected to draw our lines and levels will also be swings from which we can draw our Fibonacci retracement and extension levels. In that regard, I have found that some of my students have gone about finding the swings in the market before drawing their lines and levels, and that's perfectly acceptable. You can certainly try that and see if it helps.

Step Two of Building a Trade: Find the Swings in the Market

We are already familiar with how to find swings with minor high and minor low patterns. While actual swings are typically calculated from a percentage-based move rather than a pattern like minor highs and lows, and you can use either. Typically I will initially teach new traders how to find minor highs and minor lows because they are simple patterns that are easy to recognize until your eyes are trained to find actual high and low swings by just glancing at the chart. And believe me, there will be a time when most of these patterns, trend-

lines, levels, support, and resistance will just seem to pop out from the chart.

Swings are commonly calculated by a percentage move. So if we choose a percentage move of 5% for example, then prices must move up at least 5% from a low for it to become a confirmed swing low. It's just the opposite for swing highs. Since this is more mathematical, and you certainly don't want to get bogged down in calculating this for each swing, let's move on to minor high and lows.

Let's briefly review some charting examples. The first chart example is of the euro on a 180-minute time frame and shows quite a few minor highs and minor lows (Ch 19.3). As traders it is our job to take these patterns and decide which we feel is the most timely and relevant. Remember, in order to draw the most accurate Fibonacci levels as possible, we want to find what would best be described as the "last major move."

The move from *a* to *b* is not a consideration because it is obviously not a major move (Chart 19.3). The move from *c* to *d* is certainly a good option and at the time would have been a good choice. Finally we have the most recent move from *e* to *f* or from *e* to *g*. Since *g* is higher than *f* it would be a better choice since there was not a significant retracement between *f* and *g*. Let's examine the move from *e* to *g* and determine whether it is indeed the last major move.

The move from *e* to *g* is the last or most recent move, so the first criterion is met. But the most important criteria is whether it is the major move. There are two questions to ask when we seek to qualify what is a major move:

Question 1.

Is there a swing higher or lower than the swings (or minor high/minor low) that

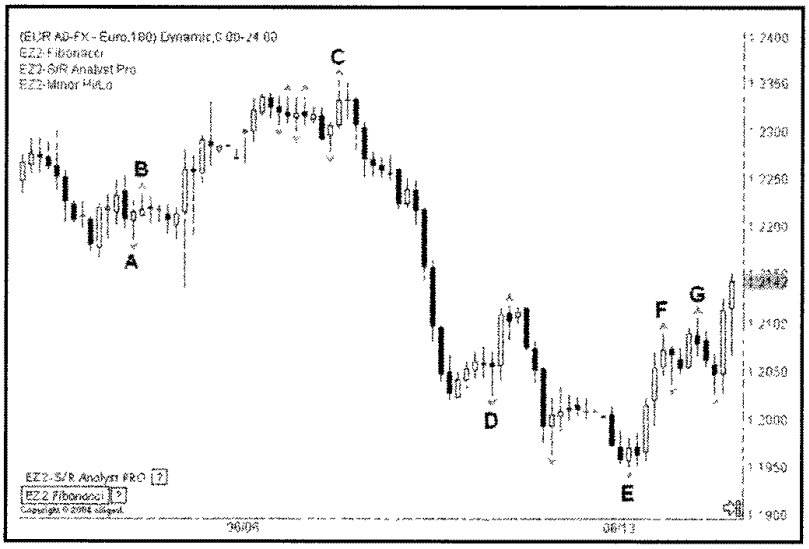

Chart 19.3

we're looking at, AND has there been any significant retracement at, all between those two points? In this case, we can answer no. There is no minor low that is lower than *e* and no minor high that is higher than *g* and the market has not retraced significantly between these two points. It is vital that the last major move be a rally or sell-off that has not already been retraced. That is the reason we would not consider a move from *c* to e because there was a retracement in between these two points.

Chart 19.4

Question 2.

Are the swings (or minor) high and low too close together? In this case, no. When the swings are too close together, the market cannot rally or sell off enough between the two points to offer a retracement. In this example, the market had moved from around 1.1950 to 1.2100, which is 150 pips, which offered a good range.

So we can now see that the move from *e* to *g* has satisfied the two criteria we can use to decide whether the move we are looking at is the last major move. Let's look at another example, this time the Canadian dollar on a daily chart (Ch 19.4).

I've marked the last two minor highs with *a* and *b* and the minor low with *c*. The question here is whether to use the move from *a* to *c* or from *b* to *c*. I chose this example for a purpose. It shows that there is no absolute when picking the "right" last major move. Some traders may feel that *a* to *c* would be the right move, while others would say that there was enough retracement to nullify the move. Others would say then that the move from *b* to *c* is the right one since it traveled far enough and had no retracement in between. The argument against the move from *b* to *c* would be

that there is a higher swing/minor high than the *b* level. So which is it?

Frankly, both would do. Your answer to question 1 would determine which to use. And there really is no "right" answer as long as the two criteria are met. In these situations I recommend drawing the Fibonacci levels from both levels. Many times when you do this you will see that certain levels will overlap with trendlines, support, and resistance, psychological or round numbers. I've said it before and I'll say it again: Practice makes perfect. So let's get to step three: drawing Fibonacci levels.

Step Three: Drawing Fibonacci Levels

Even though step three is focused on drawing Fibonacci levels, it is truly the step that ties all our other prep work and analysis together to give us a clear picture of any set up. This means that during this step we will be deciding upon a potential entry, profit targets, and stop-loss. And we know that our underlying thought under all this is the three "Rs": recognize, react, repeat.

The goal of any trader is to "train your eyes" in order to recognize the lines and levels that make up a trade set up. Fibonacci levels have different roles in your trading depending upon the type of trade you are setting up. For momentum trades, Fibonacci levels act as secondary confirmation, stop-loss levels, and profit targets. For swing traders, Fibonacci levels act as entry levels and profit targets. The Fibonacci levels also act as stop-loss levels for swing trades as well. Often in swing trades the entry price and stop loss will be the same level because we are buying pullbacks in an uptrend or shorting resistance in a downtrend. As long as prices do not trade beyond our entry price, our trade is valid. Of course, because of this close proximity between entry level and stop-loss, we want to give the market a little room to move or wiggle. We can also use any available support or resistance levels that we feel will contain prices, and this includes psychological or round numbers.

Alternately, when swing trading with pullbacks or bounces to the Wave we can use a different stop-loss strategy. The Wave is made up of three moving average lines. If, for example, we get a pullback into the middle line of the Wave (which means we're trading with an uptrend), we can use a break below the bottom line of the Wave as a stop-loss. We would simply place out stop between 5 and 10 pips below the bottom line of the Wave.

If we were trading with a downtrend and prices bounced into the bottom line of the Wave, we can use either the middle or top line as our stop-loss. If prices bounce into the top line of a downtrend or pullback into the bottom line in an uptrend, we simply use that line as the stop-loss with a 5 to 10 pip wiggle.

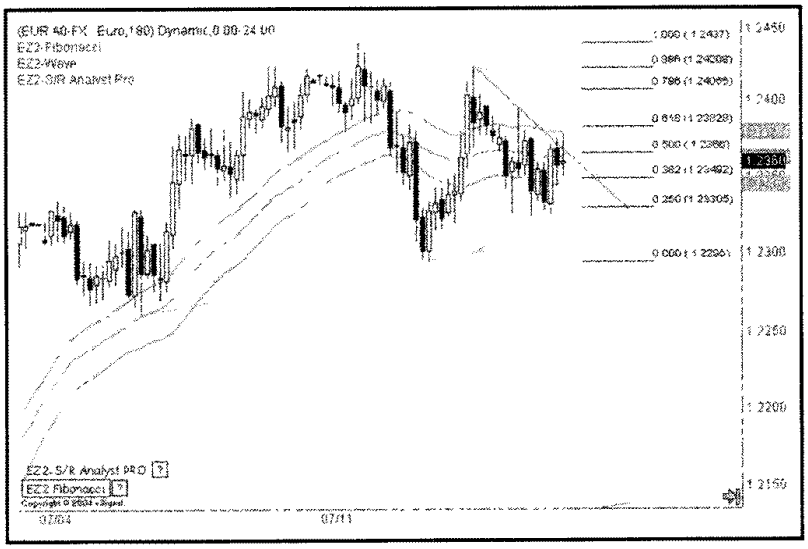

Chart 19.5

Let's focus on the two set ups you will use the most: momentum and swing. We will discuss a momentum trade set up first. For momentum trades we are looking for a trendline, support, or resistance to be broken. The Fibonacci level from the last major move can serve as confirmation; however, this is not a necessity to trade entry.

In this example of the euro on the 180-minute chart we see a potential downtrend line breakout with the 50% Fibonacci level acting as secondary confirmation (Ch 19.5). We also see an uptrend line with support levels at the 0.382 and 0.500 Fibonacci levels. These lines form a triangle or pennant formation with a three o'clock Wave. This kind of confirmation is exactly what we like to see. Because this is a momentum trade, we can take the uptrend line breakdown or downtrend line breakout. By the way, I am all the more confident of a predicable follow-through when I see a Fibonacci level acting as secondary confirmation like that of the potential downtrend line breakout. I have a high-probability breakout/breakdown level when I have a trendline, support, or resistance plus the Fibonacci level at the same price area. This is because there are actually two reasons to take the trade. Multiple reasons mean that there are more traders watching a move because there is increased attention being paid to this price level and more participation equals a better follow-through!

Another set of lines I want to bring to your attention are the second and third uptrend lines lower on the chart. Both will be support levels and potential profit targets if we take the highest uptrend line breakdown. If we do not take the first breakdown, we can see if the second or third level will set up a momentum trade. The same applies to a potential breakout regarding the second downtrend line higher on the chart.

For swing trades we will rely on pullbacks (or bounces) to enter a trade. As we have discussed before, these pullbacks will typically be to Fibonacci levels or the Wave. Unlike momentum trades where we will rely on breakouts and breakdowns, swing trading setups will not always offer us any trendlines from which to buy or short. However, we are trading retracements, and those are indeed support and resistance levels! Support is created by buyers, so when an uptrend pulls back to a level that we have analyzed is support, there is a high probability that prices will remain above this area or bounce off from there. Resistance is created by sellers, so when a downtrend bounces up to a resistance level, we expect prices to reverse at or stay below this level. There a few questions a trader asks when they are swing trading:

1. What is the prevailing trend? (If any?)
2. Where are the support levels for an ptrend entry? or Where are the resistance levels for a downtrend entry? (Whichever applies to the current trend.)
3. Is Wave traveling at Chris Clock Angles?

When we trade swing setups we must understand that if prices break the down through the pullback level or break up through the bounce level that the trade is no longer valid as your stop-loss will most likely be hit. However, I recommend giving prices a little wiggleroom at these support and resistance levels. It's best to figure in the typical five-pip spread and psychological or round numbers. By giving your swing trade stop-loss levels this wiggle, you are less likely to get stopped out by the daily fluctuation these support and resistance levels can experience and still maintain a valid trade.

CHAPTER 20

Rewriting Trade Management

Rewriting Trade Management

The Forex market, because of it's sheer mass and participation adheres very well to charting and technical analysis. It is for this very reason that traders would do well to focus their set ups and trade management to the charts rather than news and fundamentals.

Remember our mantra: If an analysis tool doesn't show us at what price to get in or get out... we shouldn't use it!

This end-of-day chart of the EUR/USD has two tools active on the chart: trendlines and Fibonacci levels (Ch 20.1). These time-tested, classic tools answer the three questions I ask myself when I am entering and managing a trade: where to enter, where to place my stop-loss, and where are my profit targets.

On May 3, the market consolidated (Ch 20.2). When that happens you know what we do, right? We wait for a breakout to the upside or a breakdown to the downside. The chart shows that we have a major uptrend to break as well as another support level and a major downtrend to break as well as the 0.382 Fibonacci level. All chart patterns boil down to support and resistance, and that includes downtrend and

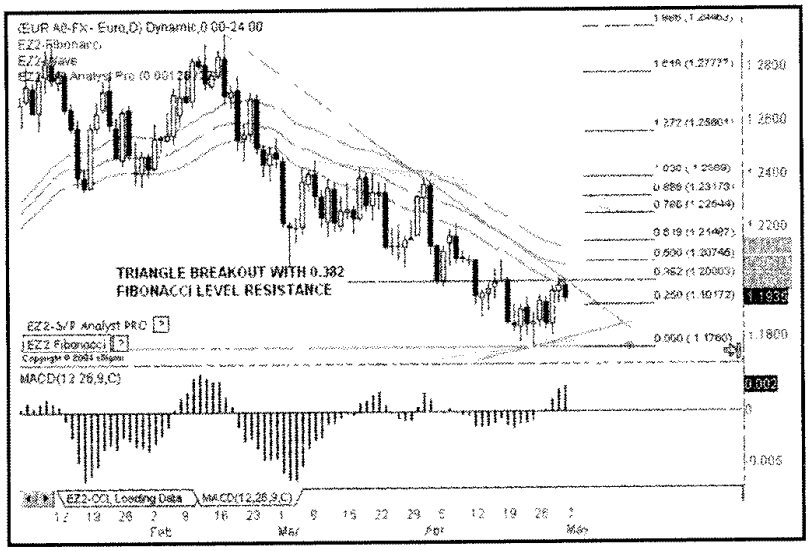

Chart 20.1

uptrends which in this example have formed a triangle.

On May 5 we see that the market broke out to the upside and traded through the first profit target at the 0.500 Fibonacci level and the second profit target at 0.618, and stalled just above the 1.21487 price level (Ch 20.3). Each of these Fibonacci resistance levels becomes support as prices trade up through them and can effectively be used as trailing stops if prices reverse. The 0.618 can now be seen as a support level and a near term trailing stop. Be sure to give it a 5 to 10 pip wiggle. We could also use the 0.500 level as a stop-loss level, but this depends upon how much profit you are willing to give back to the market. Both the 0.618 and 0.5000 levels are viable options. Personally, I am not wild about the idea of giving back 70-plus pips. But again, it's your decision.

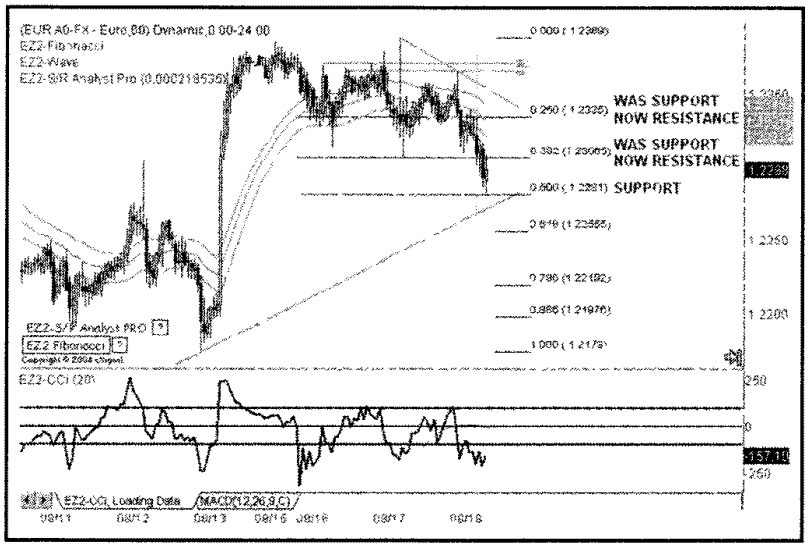

Chart 20.2

As we see here (Ch 20.4), prices did weaken and we see that the 0.618 level was indeed the reversal level and prices have broken the 0.500 Fibonacci level, thus closing out the long position.

Chart 20.3

The next chart shows the view as of May 10. The EUR/USD has continued to sell off, and a large consolidation pattern (a downtrend and uptrend trying to converge) has begun to develop (Ch 20.5). Since we have a new last major move we are looking at a new set of Fibonacci levels. Remember, we must continually monitor rallies and declines to be sure that we have the most recent and relevant Fibonacci levels. Prices are currently trading at the 0.786 Fibonacci level and had already bounced off the 0.886 level earlier. Having these levels on the chart helps a trader gauge the strength of the market as well as have potential support and resistance levels laid out on the chart.

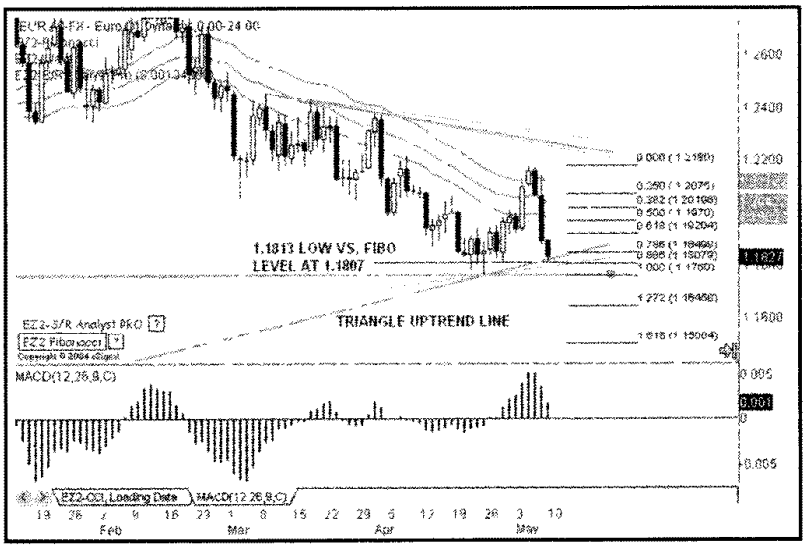

Chart 20.4

Confirmation of a potential break of the uptrend line would coincide with the 0.886 Fibonacci level. There is also a horizontal support level at the 1.000 (full retracement) level which is also support in itself. This support level (with secondary confirmation) would be the first potential profit target level if prices break down below our entry level at the 0.886

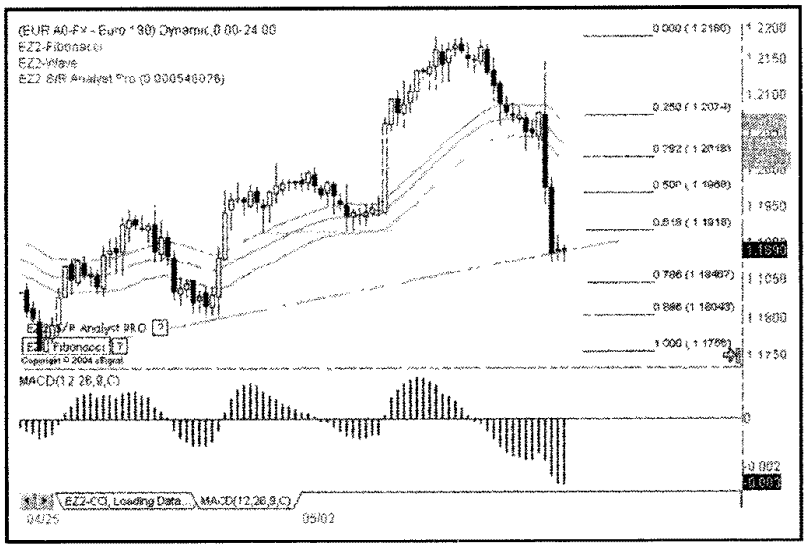

Chart 20.5

level. Let's rewind and take a look at this set-up on an intraday chart (Ch 20.6).

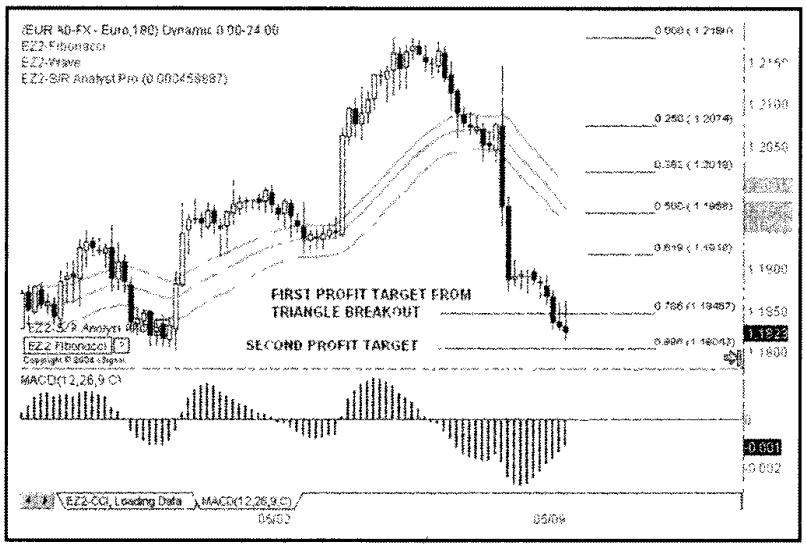

Chart 20.6

The intraday view is of the 180-minute chart. Here we see prices resting right on the uptrend line. To the upside we see a minor resistance level not far above the 0.618 Fibonacci level. The uptrend line and the minor or soft resistance level are forming two breakout levels that we will watch closely. I will refer to a support or resistance level as *soft* when it is not perfectly horizontal, which means that the prices connected to make the level were not at the same price. If the prices are very close or at the same price level and make a perfectly horizontal support or resistance level, I will refer to it as *firm*.

Here's the view seven candles later: Prices broke the uptrend lines and the sell-off sliced down through the first profit target at the 0.786 Fibonacci level and headed toward the second target at the 0.886 (Ch 20.7). The next chart is just four candles later and shows a great example of when prices fall short of a target and what can happen.

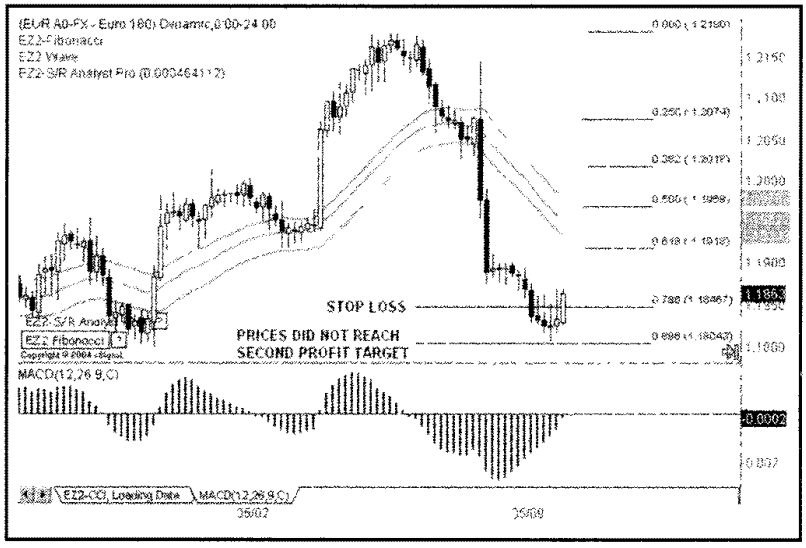

Chart 20.7

Here we see that the low reached 1.1807 while the profit target was 1.1804... three lousy pips, but that's the way trading can go (Ch 19.8). Since we have the 0.786 Fibonacci level just above, it makes for a perfect trailing stop. In this scenario, our Fibonacci levels acted as

1. A potential stop-loss at the onset of the triangle break
2. The initial profit target once the break confirmed
3. A trailing stop when the second profit target was not hit

By using Fibonacci, traders can use the levels to confirm entries as well as exits. There are a number of Fibonacci retracement and extension levels that can be used; however, I personally use these: .250, .382, .500, .618, .786, .886, 1.272, 1.618, 1.886. Initially this may seem like a lot of levels to track but when considering that a trade can be triggered anywhere within a set of Fibonacci retracement or extensions, you will see that there will be levels on both sides of the entry pinpointing stop-loss levels as well as profit target levels.

Remember that trading is the process of asking and answering questions. The trick is in knowing when or what price will trigger us to begin asking questions. Each of the trendlines, support, and resistance levels on a chart can be considered "decision levels," because when prices reach these levels we should begin asking ourselves: Will prices breakout or breakdown here? Will prices reverse here? Will prices level and find support or resistance here? Decision levels keep us from asking questions at the wrong price levels, and they also allow us to relax because each new bar or candle doesn't create an anxiety that makes us feel that we should be "doing" something. This is especially true for short-term intraday traders because prices are constantly moving and changing.

Chartists and technical traders rely on price and chart patterns because fundamentals and news cannot give a trader exact price levels at which to buy and sell. One error some traders make is using fundamentals alone to trigger a trade. While a trader has the option of timing an entry with the release of an economic report, if they already have a entry price set by the charts, there still is no way to accurately measure to what degree any piece of news has already been discounted into the market. Since we cannot gauge the reaction to this news event, this results in a high-risk entry. There is simply no way to generate a specific price at which to enter, place a stop-loss, or profit target based solely on fundamentals or news.

One of most common ways many traders decide upon stop-loss levels is to use a fixed point or percentage based stop-loss. This no doubt has come from the influence the money-management style from large funds and portfolios have had on trading. The error in this is that traders are neither creating portfolios nor investing. As we have discussed in Chap. 13, Trading Versus Investing, trading is a completely separate activity which has its own rules. Most commonly, traders will enter a trade based upon some sort of action at a specific price point, whether that trigger is a pullback, bounce, breakdown, or breakout. Our entries are triggered by price, so should our exits. Exits can be stop-loss or profit targets.

As I've shown here, by using Fibonacci to manage the trade, a trader does not have to use fixed points or percentages to decide upon stop-loss or profit targets. Besides, we know that the market neither acknowledges nor cares that a trader may only tolerate a 2% or 4 points of loss or that he or she is setting a profit target for $400 or 10 points. These fixed points have no basis within the market.

Think about it this way: Chartists and technical traders believe that by monitoring price action and price patterns they can formulate a trade, specifically an entry. However, far too many of these same traders seem to abandon this belief in price and patterns when deciding upon stop-losses and profit targets which suddenly seem to be based on a dollar value. (e.g.. "I want to make $500 on this trade and only want to risk $100.") This is completely without merit! When in a long trade, we should be looking to support levels below our entry price as potential stop-loss levels and if we are in a short trade we should be looking to a resistance level above our entry for stop-loss levels.

Even when using the charts, there is no one "right" price to place a stop-loss. This decision also depends on the rules a trader uses to qualify or disqualify a trade based upon whether the trade is a momentum or swing trade. Some traders have deeper pockets and use longer time frames which results in a different risk tolerance than a trader with less capital and a shorter time frame. The charts offer flexibility and the ability to decide—before entering the trade—what the stop-loss and initial profit target is. And by using the charts, these decisions are not made arbitrarily! Instead, we can now plan ahead and decide upon these levels by using Fibonacci levels, support, and resistance levels.

CHAPTER 21

A Trade Going Astray

A Trade Going Astray

Fellow Traders,
This is my letter to you. Once upon a time, like you, I began this journey of learning how to trade. I wanted to learn to do it well and quickly. And like you, well maybe some of you, it became an all-out obsession. Do 14-hour days in front of the PC sound familiar?

That was me. A great weekend was lying out by my pool or at the beach with a book on charting or technical analysis.

As I continued on my relentless pursuit of reading and watching whatever I could get my hands on, I discovered all those books, courses, videos, and websites that told me that *they* had the "secret" and that *they* caught all the turns, tops, bottoms. When you are looking for an edge, the "holy grail of trading" song calls to you. What you don't know is that there are already so many traders that were called by the same song and wrecked their ships on the rocks. (Forgive my Ulysses and the sirens analogy, it's the English major in me). There is a fact that when I accepted it, it became the turning point in my trading, and it is this: Not all market moves are mine to profit from. Not every move is for me. A move that makes money for one trader will be a loss for another or won't even register a setup for yet another. *That's the real secret.*

As I think back, it really was a pivotal moment in my trading education because once I accepted this fact I stopped my "search." I stopped looking for why my way didn't make money when I read on a forum or saw on a chat that someone else made money. I stopped trying to figure out why I couldn't capture every move and why some moves left me behind. *I know why now: Not every move is for me.*